Congress of the United States
U.S. House of Representatives
COMMITTEE ON WAYS AND MEANS
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May 17, 2007

The Honorable Susan C. Schwab
U.S. Trade Representative
600 17th Street N.W.
Washington, D.C. 20508

Dear Madam Ambassador:

We are filing this petition under section 301 of the Trade Act of 1974 to request the Administration take action to end the Government of China's undervaluation and manipulation of its currency, the renminbi (RMB). In particular, we are calling on the Administration to request formal consultations with China under the relevant provisions of the World Trade Organization agreements and to file a formal dispute settlement case within 60 days if those consultations do not resolve this serious and urgent problem that is causing so much harm to U.S. farmers, workers, and businesses.

Members of Congress made similar requests in September 2004 and April 2005. The Office of the U.S. Trade Representative (USTR) was unwilling to accept those requests because, it stated, it did not want to interfere with efforts by the Department of the Treasury to address the issue through dialogue with the Chinese authorities. Nevertheless, USTR made clear that it had "serious concerns" about China's currency policy: "China is now ready to move toward a flexible, market-based exchange rate and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions."

Now, more than two years later, there has still been no real progress made on this issue. To the contrary, in December 2006, U.S. Federal Reserve Chairman Ben Bernanke stated that "the situation has likely worsened recently." He stated that the undervalued RMB operates as an "effective subsidy" that acts as "an important distortion in the Chinese economy." While economists have estimated that the RMB is undervalued in the range of 15 to 40 percent, the RMB has appreciated by just 0.2 percent, in real terms, since April 2005.

In November 2005, Treasury reported that China's foreign exchange regime "remains, in practice, a tightly managed currency peg against the dollar." Treasury called on the Chinese authorities to take action "by the time this [semi-annual] report is next issued." Treasury reported no real progress in its next report (May 2006) – or in the most recent report (December 2006). Today, the Government of China's foreign asset reserves (an indication of its level of intervention in the currency markets) exceed $1.2 trillion, up from $243 billion in June 2002. Meanwhile, the U.S. trade deficit with China grew to $233 billion in 2006, a new record.

Unfortunately, efforts over the past four years to cajole China to revalue its currency have not borne fruit. We therefore request that you initiate an investigation under Section 301 of the Trade Act of 1974, with a view to ending, finally, the undervaluation and manipulation of the RMB.

We also ask that you consider taking action to address the undervalued Japanese yen. As you know, the yen is at its lowest level in more than 20 years, and *The Economist* magazine recently described it as "perhaps the world's most undervalued currency." Past and current actions by the Government of Japan (including the accumulation of $900 billion in foreign asset reserves and a monetary policy that keeps interest rates abnormally low) are a major factor in the value of the yen today.

Thus, the situation with both China and Japan is a history of massive government intervention in, and other management of, its markets – a major factor in combined foreign exchange reserves of more than $2 trillion. This kind of activity distorts markets, harming in real terms businesses and working people in the United States.

We respectfully submit that the time for talk has long passed and action should not be further delayed.

Sincerely,

Charles B. Rangel
Chairman
Committee on Ways and Means

Sander M. Levin
Chairman, Subcommittee on Trade
Committee on Ways and Means

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SUMMARY

The Bipartisan China Currency Action Coalition is a group of U.S. Members of the House of Representatives, each of whom represents U.S. workers, farmers, family-owned businesses, and other businesses injured by the Chinese currency's undervaluation, which has been estimated at 15 to 40 percent or more. Between 1994 and July 2005, China pegged the yuan to the U.S. dollar. Over approximately the last five and a half years of that period, the value of the yuan averaged 8.2775 yuan to the U.S. dollar and fluctuated in the range of ±0.1 percent (i.e., equal to roughly 1/100th of one U.S. cent). During the last year of that period, the range narrowed even further to ±0.01 percent (i.e., equal to about 1/1,000th of one U.S. cent) around the average of 8.2771 yuan per U.S. dollar.

On July 21, 2005, China revalued the yuan by 2.1 percent to 8.11 yuan to the U.S. dollar and announced the replacement of the yuan's peg to the U.S. dollar with reliance upon a basket of currencies and the institution of a daily trading band of ± 0.3 percent. Nearly two years later, the weighting of this basket of currencies has not been made public, and, in fact, it appears the yuan remains largely pegged to the U.S. dollar. As of May 2007, the yuan's nominal rate of exchange is approximately 7.70 yuan to the U.S. dollar, but after relative rates of inflation in China and the United States are considered, the real rate of exchange is probably about what it was before the revaluation in July 2005.

China is the only major trading country in the world with what effectively is still a fixed-peg currency system. By definition, this regime requires an expansive role in the market by the Chinese government, because it alone can manage the imbalances in supply and demand caused by its determination to maintain an undervalued price of the yuan contrary to market forces and given China's soaring volume of exports. China permits foreign direct investment that it favors, but otherwise has a labyrinthian array of currency controls on the holding and use by businesses and individuals of current- and capital-account inflows of foreign exchange. In effect, the Chinese government absorbs foreign currency by printing and circulating yuan in exchange. See Exhibit 1.

China's yuan presents an extreme and unique case of currency undervaluation and manipulation. While economists and academicians debate the extent of the yuan's undervaluation, there is a strong consensus that the yuan is significantly undervalued. See Chart on p. 20.

China's undervaluation of the yuan is fueling serious trade imbalances. First, China's official trade data significantly understate its global trade surplus and the degree of the yuan's undervaluation. See Section II.D. If China's import/export data are replaced by the corresponding export/import data of China's 39 largest trading partners (which have accounted for roughly 90 percent of China's total trade since 1999), it is evident that the United States and the rest of the world are running substantially greater trade deficits annually with China than China's official trade data show and that these deficits have become progressively worse over the last several years especially. This conclusion is reached even after adjustments are made for transshipments through Hong Kong and after f.o.b./c.i.f. valuation inconsistencies are reconciled.

Thus, the trade surplus of China with the United States catapulted from $33.8 billion in 1995 (according to U.S. data) to $235.4 billion in 2006 (again according to U.S. data). China's data show, by contrast, a $9.4 billion trade surplus in 1995 and a $147.3 billion trade surplus with the United States in 2006. See Chart on p. 33. Likewise, in 1999 China reported a trade surplus of $37.7 billion with its 39 principal trading partners (including the United States), but the data of those 39 trading partners indicate that China's trade surplus in 1999 was $140.6 billion. In 2006, the corresponding figures were $217.1 billion and $470.1 billion, respectively. See Chart on p. 36. If trade between China and the United States is excluded from the calculations, China's trade surplus in 1999 was reported by China as $14.2 billion, but was reported by China's major trading partners other than the United States as $71.5 billion. In 2006, China reported its trade balance apart from the United States as a surplus of $69.9 billion, while China's main trading partners other than the United States computed China's surplus as $234.7 billion. See Chart on p. 39.

Second, China's undervalued yuan has encouraged and facilitated foreign direct investment into China. Between 1994 and 2000, total utilized foreign direct investment increased by almost 21 percent and then between 2000 and 2006 rose by 55 percent as growth accelerated. In the last several years, total utilized foreign direct investment in China has been approximately $60 billion annually. Moreover, in 2004, the last year for which it is understood China's government is releasing such data, there were over $153 billion of total FDI contracted in China. See Chart on p. 42.

Third, China's undervalued yuan has also generated an accumulation of foreign-exchange reserves that is excessive. In 1995, the year after the yuan was pegged to the U.S. dollar, China's foreign-exchange reserves were $73 billion. In 2000, China's foreign-exchange reserves were $165 billion. After the yuan's revaluation in July 2005, China's foreign-exchange reserves were 1.066 trillion dollars by the end of 2006, significantly in excess of one-third of China's Gross Domestic Product. Furthermore, China's accumulated foreign-exchange reserves are far in excess of the IMF's prudential guidelines of 4-6 months and 180 percent of short-term debt.

Fourth, the increase in foreign-exchange reserves is requiring China to increase its money supply in order to purchase the foreign-exchange reserves and maintain the undervalued exchange rate of the yuan. Between 2000 and 2006, China's money supply has been growing annually by an average of 15-18 percent, see Chart on p. 47 and p. 81, and this substantial increase in the money supply is overheating China's economy, which has been expanding at an average annual rate of about 10 percent over the past several years.

In the absence of an orderly realignment and revaluation of China's exchange rate to reflect underlying economic fundamentals, China's economy will continue to overheat, creating greater imbalances and pressures on an economy historically characterized by booms and busts, ultimately resulting in a financial crisis.

China's maintenance of an undervalued exchange-rate regime violates various international legal obligations of China at the expense of the United States. China's manipulative undervaluation of the yuan constitutes a prohibited export subsidy (pp. 50-71) and frustrates the intent of and breaches basic principles of the World Trade Organization's General Agreement on Tariffs and Trade (pp. 71-77 and Attachment). At the same time, China's undervalued-exchange-rate policy unjustifiably gives China an unfair competitive advantage over the United States and discriminates against U.S. exports of goods and services contrary to Articles IV and VIII of the International Monetary Fund's Articles of Agreement (pp. 78-83).

As our constituents have repeatedly informed us, China's undervalued exchange rate burdens and restricts U.S. commerce. U.S. imports from China and the U.S. trade deficit with China are soaring, accounting for 56 percent of the increase in imports of manufactured goods between 2001 and 2003, and have risen further since then. If longer-term historical trends in exports and imports prevail, the annual U.S. trade deficit with China will increase from $235 billion in 2006 to $548 billion by the end of annual 2011. Even if the growth rates in 2006 continue, the deficit will still reach $442 billion in annual 2011. See Chart on p. 90.

Moreover, U.S. domestic market share is being displaced by U.S. imports from China. According to an import penetration analysis on a sector-by-sector basis, 60 percent of China's increased import penetration of the U.S. market for manufactured goods between 2000 and 2003 displaced domestic U.S. producers' share. This displacement is equivalent to a $31-billion loss in U.S. domestic production. See pp. 91-97. China's undervalued exchange rate results in extremely low prices on China's exports to the United States, unfairly pressuring domestic firms by undercutting their pricing power.

The undervalued exchange rate also adversely affects U.S. exports. While U.S. exports to China rose by 33 percent in 2006, much of the increase occurred in raw and intermediate materials. In fact, China's imports from the United States were the slowest-growing compared with imports from China's largest foreign suppliers. The U.S. share of China's total imports declined to a new low of 8.0 percent in 2004. If its share had not fallen, U.S. exports to China would have been $35 billion higher in 2004 than they actually were – a significant difference of about 50 percent.

U.S. affiliates are not causing the surge in U.S. imports from China. About 50 percent of U.S. imports from China come from foreign-invested enterprises, the great bulk of which are non-U.S. companies. Moreover, relative wages are not a primary factor driving U.S. imports from China, because labor costs are a relatively small fraction of the total cost of manufacturing.

The Bipartisan China Currency Action Coalition seeks the immediate elimination of the undervaluation of the yuan. If China refuses to eliminate the undervaluation, the United States

should pursue a formal dispute settlement action under the World Trade Organization. If such action is successful, and China does not bring its policies into conformity with its WTO obligations, the United States should pursue WTO-consistent remedies against China.

I. INTRODUCTION

This petition is presented by the Bipartisan China Currency Action Coalition pursuant to Section 302(a) of the Trade Act of 1974, as amended (19 U.S.C. §§ 2412 et seq.) ("the Trade Act"), and the regulations of the Office of the United States Trade Representative ("USTR") at 15 C.F.R. Part 2006 (2006). This petition requests that action be taken under Section 301(a) to end the misaligned undervaluation and manipulation of the yuan[1] by the Government of the People's Republic of China ("China") and to ensure active enforcement of China's WTO obligations if China fails to do so.

A. The Petitioner

The Bipartisan China Currency Action Coalition is a group of U.S. Members of the House of Representatives, each of whom represents U.S. workers, farmers, family-owned businesses, and other businesses in manufacturing and agricultural fields that are directly affected economically by the Chinese currency's undervaluation.

B. Statutory Basis for This Petition

As described in the balance of this petition, China's maintenance of an undervalued-exchange-rate regime denies and violates international legal rights of the United States, is unjustifiable, and burdens and restricts U.S. commerce, contrary to 19 U.S.C. § 2411(a)(1).

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[1] The Chinese currency is commonly and traditionally referred to as the yuan, which is the convention used in this petition. The official name of the currency is the renminbi, of which the yuan is technically a denominational unit. In referring to a monetary amount in Chinese, the correct usage, for example, is "ten yuan renminbi," rather than "ten yuan" or "ten renminbi." In English, there is no distinction between denominational units and names, so petitioner has simply used yuan.

C. Foreign Country That Is the Subject of This Petition

This petition addresses the acts, policies and practices of China.

D. Petitioner's Economic Interest

The members of the Bipartisan China Currency Action Coalition are U.S. Members of the House of Representatives acting on behalf of their constituents whose businesses and jobs increasingly have been undercut and lost as the result of China's maintenance of an undervalued exchange-rate regime. By maintaining an undervalued-exchange-rate regime that does not reflect market conditions, China unlawfully and unreasonably has been bolstering the Chinese economy at the expense of U.S. industry, workers, and farmers. Exports from the United States to China and to third countries have been stifled, even as Chinese-origin goods have inundated the United States and other markets abroad. The Chinese government's continued undervaluation of the yuan is at the center of this dangerous imbalance. The U.S. Representatives who are filing this petition submit that the health and continued well-being of the U.S. manufacturing base, as well as of related service providers and all they represent for the national security and standard of living of the United States, are at stake and threatened by China's mercantilism.

E. Requests for Other Relief

The Bipartisan China Currency Action Coalition has not filed and is not filing at this time for other forms of relief under the Trade Act of 1974 or under any other provision of law with respect to the acts, policies, and practices of China that are the subject of this petition. The Bipartisan China Currency Action Coalition reserves the right to file for other forms of relief under the Trade Act of 1974 or other provisions of law with respect to the acts, policies, and practices of China that are the subject of this petition.

F. Public Hearing

Petitioner hereby requests that a public hearing be held in this matter. Because USTR has already acknowledged, "We do not need to conduct an extensive 301 investigation to know that we have serious concerns about China's currency policy," such a hearing should not delay action under Section 302(a) of the Trade Act of 1974 (19 U.S.C. § 2412).

II. CHINA PRESENTS AN EXTREME AND UNIQUE CASE OF CURRENCY UNDERVALUATION AND MANIPULATION THAT HAVE RESULTED IN A HUGE CURRENT-ACCOUNT SURPLUS FOR CHINA TO THE DETRIMENT OF THE UNITED STATES AND THE GLOBAL ECONOMY

A. China's Importance In the Global Economy and Foreign-Currency Regime In Combination Are Having An Unparalleled Disruptive Influence

As of late 2006, China became the second largest trading partner of the United States, in contrast to its being the United States' third largest trading partner in terms of overall trade volume as recently as of the end of 2004. In recent years, China has been and remains the source of the United States' largest bilateral trade deficit in its history. Indeed, it is almost certain that no two countries have ever produced such an unbalanced pattern of trade as that between the United States and China. Moreover, while the sheer magnitude of this imbalance is unprecedented in its own right, the speed at which it has developed and continues to deteriorate is cause for serious concern. Until now, global market forces had never managed to produce such a state of disequilibrium in trade patterns and financial flows. As detailed at length throughout this petition, the root causes of this extreme imbalance are China's emergence as an international trading powerhouse fueled by its maintenance of far-reaching policies to interfere with market forces to its advantage. While these gains have come largely at the expense of the United States, there is ample current evidence, as well as historical precedent, to suggest that these policies are running tremendous risks not only to China itself, but also to the global trading environment and economy at large.

Understandably, myriad factors underpin this unparalleled shift in trade and investment flows between China and the United States. Nevertheless, China's foreign-currency regime, which relies on expansive controls, restrictions and intervention by its central government to thwart market-driven disciplines and normal adjustment patterns, is a primary if not predominant factor. China's undervaluation and manipulation of its foreign-exchange market have produced a massive and self-serving distortion in the global trading and financial system, primarily to the detriment of the United States. These effects are clearly manifest in China's soaring trade surplus, foreign direct investment inflows and foreign-exchange reserves, whereas, for the United States, the effects are evident in its burgeoning trade deficit and massive increase in foreign debt, an increasing proportion of which is now held by China.

China's command and control of its foreign-exchange market are standing characteristics consistent with China's close management of its broader economy. The extent and persistence of the Chinese government's interference in the foreign-exchange market have a long tradition of producing endless cycles of distortions and imbalances requiring even more extensive interventions. Until recently, China has borne the brunt of the resulting inefficiencies and volatility caused by such interference. Since joining the WTO in December 2001, however, as China has become more integrated with the global economy, these burdens and distortions increasingly have been migrating beyond China's borders, with the United States at the end of the path of least resistance.

China's control of the foreign-exchange market begins with its exchange-rate regime. While China has reported to the International Monetary Fund ("IMF") that it employs a "managed-float" type of regime, in practice China's regime is better classified effectively as a

"conventional fixed-peg."[2] This type of regime establishes a set parity value of the yuan vis-à-vis the U.S. dollar. Due to the very narrow range of fluctuation permitted by the Chinese government around this set parity value (± 1 percent or less), the peg (or value) is considered "fixed."[3] While the nominal rate of exchange between the yuan and the U.S. dollar has gone from approximately 8.28 yuan to its present 7.70 yuan to the U.S. dollar since the yuan's 2.1-percent revaluation on July 21, 2005, the real rate of exchange effectively has remained about the same after the relative rates of inflation in China and the United States over this period of time are considered.

Among the many different types of regimes in use around the world, fixed-peg regimes, by their very nature, tend to require the greatest degree of governmental intervention and control by monetary authorities in order to maintain the relative value of the currency close to its parity value. Consequently, the use of fixed-peg regimes is extremely limited, and only 30 countries other than China employ such regimes.[4] These countries generally have small, lesser-developed economies with trade and financial flows that are relatively minor and/or in balance. China

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[2] As outlined in detail in Exhibit 1, China's failure to properly classify its foreign-exchange regime led the IMF in 1999 to alter its formal classification scheme by relying on its own staff's assessments of the regime in use rather than that reported by individual members.

[3] Between 2000 and mid-2005, according to the Federal Reserve, the value of China's currency averaged 8.2775 yuan to the U.S. dollar with interim fluctuations in the range of ±0.1 percent (i.e., equal to roughly 1/100th of one U.S. cent). During the last year of that period, the range narrowed even further to ±0.01 percent (i.e., equal to about 1/1,000th of one U.S. cent) around the average of 8.2771 yuan per U.S. dollar. The weighting of the basket of currencies announced by China upon the yuan's modest revaluation in July 2005 has not been made public, and it appears from the real exchange rate between the yuan and the U.S. dollar that the yuan effectively remains pegged to the U.S. dollar as of May 2007.

[4] The countries that peg their currencies specifically to the U.S. dollar are, of course, even fewer in number and fall loosely into two groupings. The first comprises countries that are relatively dependent on the United States for a large portion of their otherwise limited overall trade. The second comprises countries with exports that are dominated by international commodities traded in U.S. dollars, such as oil producers. China fails to fit into either of these general groupings.

stands out as a glaring exception, dwarfing the next two largest countries in this group – Malaysia and Saudi Arabia.[5]

From a structural standpoint, therefore, China is essentially alone in its continued use of what effectively is a fixed-peg regime given its size and integration with the global economy. Other major trading partners of the United States, including Mexico, Canada and the European Union, allow their respective currencies to float freely against the U.S. dollar such that market forces determine the respective currency values that prevail under different economic conditions. Only China holds firm to what amounts to a conventional fixed-peg arrangement alongside comparatively minor trading partners and despite the unprecedented imbalances and distortions that have resulted.

It is emphasized that the use of a fixed-peg regime is not necessarily problematic or distortional in and of itself. As detailed both above and further in Exhibit 1, however, the use of fixed-peg regimes tends to be narrowly confined for good reason. The desirability of and need for exchange-rate adjustments increase in direct proportion to the volume of trade and investment flows, to the benefit of all sides in the web of trading and investment relationships around the globe. When trade and financial flows are relatively insignificant or balanced, they simply are not capable of generating significant distortions or persistent disequilibria among countries and between partners. Any comparatively minor imbalances that do arise typically are easily managed via the governmental interventions that are characteristic of fixed-peg regimes.

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[5] Malaysia experienced a currency crisis in 1997-1998 under a fixed-peg regime and is actively considering adopting a more liberal regime, while Saudi Arabia is the world's largest oil exporter.

Once trade and financial flows exceed a certain point,[6] however, significant distortions and disequilibria can arise and easily overwhelm a government's ability to sustain the extensive degree of on-going intervention required to maintain a relatively fixed rate of exchange. This intensive governmental involvement explains why all other countries with significant trade and financial flows tend to employ more liberal currency regimes. Once again, China stands in sharp contrast, not just in terms of its nominal regime and the yuan's real exchange rate with the U.S. dollar, but also in terms of the imbalances that have resulted and the extent of governmental intervention and control that have been essential to maintain this regime. China has fostered these imbalances via wide-ranging restrictions on the supply and demand (and ultimately the price) of the yuan and other foreign currencies in its economy, as summarized below.

By definition, China's essentially conventional fixed-peg regime requires an expansive role in the market by the government, because it alone is in a position to manage the resulting supply and demand imbalances that stem from its determination to maintain in real terms a fixed price of the yuan in the face of market forces that would lead to a markedly different result. Moreover, the extent of the government's involvement in the market increases in direct proportion to the imbalances it creates by interfering in the first place. The measures employed by the Chinese government encompass both supply- and demand-side controls that effectively negate the pressures that would otherwise cause the value of the yuan to fluctuate, as the currency of every other major trading country does.

As Chinese exports and foreign-direct-investment inflows have ballooned in recent years, the supply of foreign exchange in China has likewise increased. Confronted with this huge

[6] While there is no established ceiling or reference point, $30-$50 billion in annual trade with the United States appears to constitute a significant threshold, as detailed in Exhibit 1.

influx of foreign currency, China's government either must permit more demand for foreign currency in its economy or must create that demand artificially via its own intervention in the market to absorb the excess supply. The Chinese government has favored the latter approach through its restrictions on and even abolition of normal supply-and-demand forces,[7] preferring to purchase the ever-increasing surpluses of foreign exchange directly in order to remove those surpluses from the Chinese market.

As the Chinese government restricts holdings and authorized uses of foreign currency, the only alternative in the Chinese economy is to convert the foreign currency to yuan. Thus, the demand for yuan increases proportionally with the excess supply of foreign currency, which would normally lead to an increase in the value of the yuan. Instead, the Chinese government, having created the excess supply of foreign currency, has stepped in and mediated the corresponding excess demand for yuan by simply printing more yuan in order to absorb the surfeit of foreign currency and clear the market at the price desired and set by the government.[8] As a result, China's official foreign-exchange reserves, along with the supply of yuan, have

[7] The primary authorized components of foreign-exchange supply within China are limited to export revenues, the repatriation of profits earned abroad and foreign direct investment inflows, all of which remain subject to some degree of limits or restrictions. Specifically, foreign companies are required to surrender foreign-exchange earnings above certain limits, while domestic firms remain barred from retaining their foreign-exchange earnings altogether, with the exception of a partial exemption for several large, state-owned enterprises. Moreover, purchases of foreign exchange by private individuals and households remain subject to restrictions. Two other typically important sources of foreign-exchange supply – borrowing abroad and foreign portfolio investment (e.g., foreign purchases of Chinese bonds and securities) – remain strictly limited. See Exhibit 1.

[8] Due to the broad restrictions on authorized uses of foreign currency in China, the primary authorized "use" of foreign currency is conversion into yuan through the government.

soared and, in turn, have produced overheated conditions in China's economy that threaten not only China, but also the nations with which it trades and competes.[9]

China's interference with market mechanisms is most evident in its labyrinthine array of restrictions on capital-account transactions that are likewise biased in its favor. While restrictions on foreign direct inflows have been liberalized, nearly every other aspect of China's capital account is subject to advance approval, licensing or certification, explicit limits, conditional requirements or outright prohibitions, as detailed in Exhibit 1. Paradoxically, the Chinese government's interference in capital-account transactions is so extensive that there is a fundamental uncertainty in the market whether substantial capital inflows or substantial capital outflows would result if normal market conditions were permitted rather than systematically thwarted.[10] Under the existing biased structure, however, China has clearly tipped the balance in its own favor by permitting certain types of foreign investment it favors (foreign direct investment) while prohibiting or limiting other types of foreign investment and lending. Meanwhile, China's government sharply restricts its own citizens and businesses from investing or lending abroad at the same time it is forced to do so by virtue of its massive accumulation of foreign-exchange reserves.

In conclusion, China is the only major trading country in the world that effectively maintains what essentially is a conventional fixed-peg system that, in turn, can only be sustained via broad restrictions on foreign-exchange supply and demand, along with direct governmental

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[9] China's foreign-exchange-reserves growth is discussed further in Sections II.B. and II.C. of this petition.

[10] In attempting to justify its maintenance of strict capital-account controls, the Chinese government has cited the risks of rapid and destabilizing capital inflows, as well rapid and destabilizing capital outflows. It is difficult to rationalize how both risks can exist simultaneously, although the paradox illustrates just how distorted China's market has become.

control of the foreign-exchange market. Taken as a whole, the system has produced unprecedented imbalances in trade and financial flows, particularly with respect to China's relationship with the United States. Moreover, as China's position in the global economy has elevated, there has been no movement by China toward more open and market-based disciplines, because the extent of these imbalances has necessitated even greater governmental interference and distortions.

These problems are manifest in the substantial undervaluation of the yuan (see Section II.B., infra), China's soaring trade surpluses,[11] China's even more dramatic surplus in its "basic balance of payments,"[12] and, finally, China's rapidly escalating foreign-exchange-reserve holdings. While China has been reaping short-term benefits from this inequitable relationship, the United States has been suffering a trade deficit of historic proportions, which has been a significant factor in the unprecedented erosion of the U.S. manufacturing base (see Section IV., infra). Moreover, the economic effect on the United States to date, unfortunately, is considerably less than the developments that are likely to occur in just the next few years if this inequitable relationship is permitted to continue.

B. The Chinese Currency Is Significantly Undervalued

As outlined in Exhibit 1, China has a longstanding history of overvaluing and undervaluing and manipulating its official exchange rate in order to achieve various policy goals. In the 1970s, China's currency was considered significantly overvalued, as the government

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[11] China's reported global trade surplus is substantially greater than is reported in China's trade statistics. See Section II.D., below, for a detailed analysis of the substantial discrepancy between the trade surplus as reported by China compared to that reported by China's major trading partners.

[12] China's basic balance of payments is roughly equivalent to its current-account balance plus its foreign-direct-investment inflows. See further discussion of this measure in Section II.B., infra.

sought to favor the import sector in obtaining badly needed capital goods, at the cost of persistent severe losses by the export sector.[13] The gross extent of the overvaluation was made evident in China's limited and temporary experiments with free-market forces over a 20-year period beginning in 1978, when the official exchange value of the yuan was 1.60 per U.S. dollar. During these two decades, each time the government liberalized its stranglehold over the foreign-exchange market, the more the market-driven rate diverged quickly and substantially from the official rate.

On some occasions, the Chinese government would tolerate substantial differences between the devalued market-based rate and the overvalued official rate for extended periods of time. These differences were generally in the range of 50-60 percent, but often were even higher. On other occasions, China would devalue the official rate and "chase" the market rate periodically, usually with only limited success before significant divergences appeared again, leading the government either to tolerate the reemerging disparity or attempt to control it by imposing controls on the "market" rate.[14]

Finally, in 1994, China abandoned its dual-rate system by aligning the official exchange rate with the market rate via a massive 50-percent final devaluation (to 8.70 yuan per U.S. dollar). The Chinese government announced its intention to permit the exchange rate to float more freely based on market forces while still actively managing the rate as it deemed necessary.

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[13] See Guijun, Lin and Ronald M. Schramm, "China's Foreign Exchange Polices Since 1979: A Review of Developments and an Assessment," University of International Business and Economics, Beijing (May 2003).

[14] From 1981 through 1994, the Chinese government repeatedly devalued the official value of the yuan in response to its divergences from the more market-oriented unofficial value. In this time period, there were at least six major devaluations undertaken by the Chinese government, which led the yuan to fall in value from 1.54 yuan per U.S. dollar in 1981 to 8.70 yuan per U.S. dollar in 1994. See Guijun and Schramm.

The reforms and devaluation in 1994 immediately improved China's trade and investment competitiveness, which reversed the downward pressure on the yuan that had persisted practically without interruption since 1978. Within a matter of months, the yuan had appreciated by more than three percent to 8.44 yuan per U.S. dollar, leading the Central Bank to begin intervening in the exchange-rate markets to limit the rise in the yuan. In intervening aggressively in the market, China signaled its policy had officially changed to the promotion of exports and foreign direct investment. With the Chinese government limiting the yuan's appreciation, exports and foreign direct investment both began to increase strongly in 1994, thus marking the latest chapter in the government's active involvement in and control over the foreign-exchange markets.

One year later at the end of 1995, the yuan had managed to appreciate by an additional two percent to 8.30 per U.S. dollar, despite continuing interventions by the Central Bank to limit the rise. The Central Bank's intervention was manifest in a notable jump in foreign-exchange reserves that, just a few years later, would prove to be merely an initial blip. Since the end of 1995, a span of more than eleven years, China's real exchange rate has hardly wavered despite the yuan's modest revaluation of 2.1 percent in July 2005 and despite continuing and significant current-account surpluses and foreign-direct-investment inflows. However the Chinese economy is judged, the overwhelming improvements in its condition and performance between 1993 (shortly before the dual-rate system was scrapped) and today are exceptional by almost any measure – trade balance, current-account balance, basic balance, capital-account balance, and reserve position. Only one measure stands out in this respect from all the others – China's exchange rate with the U.S. dollar, which in real terms has moved very little and left the yuan severely devalued since 1994.

While there is considerable debate as to the precise degree of the yuan's undervaluation, a strong consensus exists both among economists and academicians as well as policy makers that the yuan is undervalued by a significant margin, which also is perfectly consistent with China's history.

1. Economists' Views On the Yuan's Undervaluation

In evaluating the degree to which a currency may be undervalued, economists rely heavily on two measures of the relative supply and demand for a given currency -- whether foreign-exchange reserves are accumulating and the size of the basic balance of payments. Each of these key measures indicates a high degree of undervaluation of the yuan.

As discussed in greater detail in Sections II.A. and II.C. of this petition, a country's foreign-exchange-reserve holdings can be assessed directly from its balance-of-payments data. A country's official foreign-exchange reserves fluctuate along with its combined current- and capital-account positions. Consequently, if a country's combined current and capital accounts are in surplus, as is overwhelmingly the case for China, there is a net inflow of foreign currency that is reflected by an increase in its official reserves. In effect, more foreign currency is flowing into the country than out of the country, leading to an accumulation of foreign currency in the form of official reserves. Increasing official reserves are a clear sign of currency undervaluation, as explained below.

In China's case, the tremendous increases in U.S. dollars flowing into the country from both its trade surpluses with the United States and its foreign-direct-investment inflows from the United States are met with tight controls by the Chinese government, which has sharply restricted authorized uses of U.S. dollars. The primary authorized "use" of U.S. dollars is conversion into yuan, which means that there is constant selling of U.S. dollars and buying of yuan in China. In order to forestall an unwanted appreciation of the yuan vis-à-vis the U.S.

dollar, the Chinese government intervenes in the market and purchases any amount of U.S. dollars by "selling" (i.e., printing) any amount of yuan required to keep the value of the yuan narrowly fixed versus the U.S. dollar. Consequently, the Chinese government's intervention in the market to buy U.S. dollars at a fixed price indicates that U.S. dollars are in excess supply at the prevailing rate of exchange; otherwise, the market would clear on its own and make unnecessary that the government be the demander of last resort. Thus, China's soaring official foreign-exchange reserves clearly confirm the undervaluation of the yuan.

Given that official reserve positions can fluctuate or be skewed temporarily by factors unrelated to underlying supply-and-demand forces, economists often rely on a second measure – the country's basic balance of payments – as further confirmation of relative currency valuations. Before turning to this additional indicator, however, it must be emphasized that China's massive accumulation of foreign-exchange reserves cannot be described either as a fluctuation or temporary in nature. Indeed, these huge reserves are a direct product of the Chinese government's protracted interference in the foreign-exchange market since 1994 and its refusal to permit market forces to mediate supply and demand. As a result, the government has created a gaping imbalance between supply and demand that it must neutralize in order to keep the yuan from appreciating.

A country's basic balance of payments is a subset of its overall balance of payments. The so-called "basic balance" is the sum of the country's current account (mainly its trade balance) plus the non-short-term portion of its capital account. In relation to the overall balance of payments, the basic balance ignores short-term financial and portfolio flows, as well as net purchases or sales of official reserves by monetary authorities. Due to China's strict capital-account controls, however, the non-short-term portion of its capital account is confined almost

entirely to foreign-direct-investment inflows. Consequently, China's basic balance is essentially the aggregate of its current account and foreign-direct-investment inflows.

Economists rely on the basic balance as a straightforward gauge of a country's financial relationship with the rest of the world. China's basic balance has been consistently positive for many years and is excessive relative to its Gross Domestic Product ("GDP"). Thus, China's global trade surplus annually averaged nearly U.S. $40 billion between 1999 – 2003 and then rose to $60.9 billion in 2004, to $135.1 billion in 2005, and to $217.1 billion in 2006 (according to China's data). Throughout these years, according to the data reported by China's major trading partners, as detailed in Section II.D., below), China's global trade surplus was substantially greater than China acknowledged, amounting to $285.8 billion in 2004, $385.2 billion in 2005, and $470.1 billion in 2006.

According to the Chinese government's own data, therefore, when China's global trade surplus in the last several years is combined with the average of approximately $60 billion annually between 2004-2006 of total utilized foreign-direct-investment inflows into China during the same period, the result is an estimated basic balance for China of approximately $120 billion in 2004, $195 billion in 2005, and $277 billion in 2006. See Exhibit 3, Table 5B. China's basic balance, in other words, is shown by China's official figures to have been approximately 11 percent of China's GDP in 2006.

As astonishing as these numbers are in their own right, the picture that emerges when the trade data of China's major trading partners are considered is even more exceptional. On this basis, when China's global trade surplus in the last several years is combined with the average of approximately $60 billion annually between 2004-2006 of foreign-direct-investment inflows into China during the same period, the result is an estimated basic balance for China of approximately

$339 billion in 2004, $436 billion in 2005, and $524 billion in 2006. See Exhibit 3, Table 5D. Seen from this vantage, China's basic balance is shown by the official figures of China's major trading partners to have been approximately 22 percent of China's GDP in 2006.

According to both these key measures, therefore, the yuan is clearly undervalued, and, as noted previously, the many economists who have attempted to measure the degree of undervaluation have reached the same consensus.[15] While their estimates vary considerably due to the difficulties in precisely measuring equilibrium currency values, a general conclusion

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[15] Recent studies attempting to measure the extent of the yuan's undervaluation include:

Earnest H. Preeg, "Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China. Manufacturers Alliance/MAPI, Oct. 2, 2002, (Rev. Version) at www.mapi.net. See also Ernest H. Preeg, "Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China," in C. Fred Bergsten and John Williamson, eds., *Dollar Overvaluation and the World Economy*, Institute for International Economics (Washington, D.C. 2003).

Morris Goldstein, Testimony before the Subcommittee on Domestic and International Monetary Policy, Committee on Financial Services, U.S. House of Representatives, Oct. 1, 2003; see also Morris Goldstein and Nicholas Lardy, "Two-Stage Currency Reforms for China," Asian Wall Street Journal, Sept. 12, 2003.

John Williamson, "The Renminbi Exchange Rate and the Global Monetary System," outline of a lecture at the Central University of Finance and Economics, Beijing, China, Oct. 29, 2003; available at the website of the Institute for International Economics (www.iie.com).

Jim O'Neil and Dominic Wilson, "How China Can Help the World," Goldman Sachs Economic Research Group, *Global Economics Paper 97*, Sept. 17, 2003.

Dropsy, Vincent, "China's Accession to the WTO, Real Exchange Rate Changes and Their Impact on U.S. Trade with Greater China," Department of Economics, California State University, Fullerton, March 2001.

Yang, Jiawen and Isabelle Bajeux-Besnainou, "Is the Chinese Currency Undervalued?" Occasional Paper, Center for the Study of Globalization, The George Washington University, November 2003.

Bhalla, Surjit S., "Chinese Mercantilism: Currency Wars and How the East Was Lost," Indian Council for Research on International Economic Relations, Working Paper No. 45, July 1998.

Anderson, Jonathan, "The Complete RMB Handbook," UBS Investment Research, Asian Economic Perspectives, Oct. 27, 2003.

nonetheless has emerged that the yuan is, in fact, undervalued and that the undervaluation is significant.[16]

The tabulation below summarizes the estimates of the undervaluation of the Chinese yuan.

Analyst	Publication	Date of Publication	Percent Yuan Undervalued
Preeg	MAPI	Sept. 2002	40%
Goldstein	Testimony to Congress	Oct. 2003	15-25%
Williamson	IIE Lecture	Oct. 2003	Over 25%
O'Neill & Wilson	Goldman Sachs Rpt.	Sept. 2003	10-15%
Big Mac Index	Economist	Feb. 2007	56%
World Bank	PPP Level	2000	75%
Dropsy	China's Accession to the WTO, Real Exchange Rate Changes and Their Impact on U.S. Trade with Greater China	Mar. 2001	100% (estimated real exchange rate needed for zero trade balance, as of 1999)
Yang and Bajeux-Besnainou	Is the Chinese Currency Undervalued?	Nov. 2003	27.99% based on PPP and using 1985 as fixed base year
Bhalla	Chinese Mercantilism: Currency Wars and How the East Was Lost	July 1998	10-15% as of 1998
Anderson/UBS	The Complete RMB Handbook	Oct. 2003	Nearly 25% in real terms
Goldstein	Testimony to Congress	Mar. 2007	40% or more

The CRS study, although it serves as a good summary of current undervaluation estimates, is critical of all, in general citing their reliance on non-empirical assumptions to fix an equilibrium point as to China's current-account balance and the difficulty of deriving such an equilibrium point in the presence of the comprehensive capital controls exercised by the Chinese authority. See CRS at CRS-9.[17] Indeed, a recurring theme in the relevant analyses of China and

[16] A recent study by the Library of Congress' Congressional Research Service ("CRS") cautions that "{a}lthough it is certain that the yuan would appreciate if the central bank were not increasing its foreign reserves, there is no direct way to determine how much it would appreciate." Wayne Morrison and Marc Labonte, "China's Exchange Rate Peg: Economic Issues and Options for U.S. Trade Policy," CRS Report for Congress, Dec. 5, 2003.

[17] It should be noted that the CRS report, while critical of the various academic efforts used to estimate the yuan's undervaluation, offers no alternative calculation or methodology.

the role of its exchange rate in its recent trade performance and balance-of-payments position centers on the lack of reliable benchmarks against which objective measurements can be made, not to mention inferences drawn as to causes, effects or even basic trends. In short, extensive and pervasive Chinese governmental interference in markets, both in the past and present, coupled with often dubious statistical data available on the Chinese economy and financial markets, makes even general conclusions and assessments haphazard at best. Consequently, rather than focus unduly on one particular analysis or methodology, it is perhaps more instructive to view the less disputable results. In particular, the historical data support the conclusion that the yuan's exchange rate has remained largely static since 1994 despite a massive increase in the supply in U.S. dollars vis-à-vis the yuan, now reflected in China's large and rapidly growing foreign-exchange holdings and investments in U.S. governmental debt instruments.

Thus, technical critiques of the imprecision of the extent of the yuan's undervaluation are not the focus of this discussion. The purpose here is to establish (a) that there is a widespread consensus among economists that the yuan is undervalued and (b) that the various estimates cited, even acknowledging some imprecision, generally are ranged closely and find significant undervaluation of the yuan. Placed within the context of currency movements, which typically fluctuate by only a fraction of a percent or two over many months, all of the estimates listed above indicate that the yuan is significantly undervalued. These estimates also show that China's 2.1-percent revaluation of the yuan in July 2005 and the yuan's lack of any significant real appreciation since then are totally inadequate and likely will not stem further speculative pressure on the yuan.

2. The Administration's and Other U.S. Government Officials' Views On the Yuan's Undervaluation

In addition to the estimates by the private sector just reviewed, it is important to note that the Administration itself has already acknowledged the Chinese government's distorting interference in the foreign-exchange markets and recognized that the yuan is significantly undervalued to the serious and increasing detriment of the U.S. economy. Many other U.S. governmental officials have echoed these same sentiments. A sample of the more prominent of these comments is summarized below.

In testimony to the House Ways and Means Committee on October 30, 2003, Treasury Under Secretary for International Affairs John Taylor said, "To maintain this fixed exchange rate, the central bank of China has had to intervene in the foreign exchange market.... Recently the central bank has intervened very heavily in the markets to prevent the yuan from appreciating. Since the end of 2001, dollar buying has been so great that the foreign reserves held by the Chinese government have risen by $171 billion to $384 billion (as of end-September 2003)." During 2006, China's foreign reserves exceeded one trillion dollars for the first time.

In an interview with the Associated Press ("AP") published on November 21, 2003, Treasury Secretary John Snow emphasized that the Administration's ultimate goal was to have market forces determine the value of the yuan. "Clearly, we want to hold their feet to the fire," Secretary Snow told the AP. "We are interested in seeing real movement, real action," he said. Most importantly, Secretary Snow told the AP that, as an interim step, the Administration would favor a decision by China to revalue its currency to a level more closely reflecting its fair value.

In testifying before the Senate Budget Committee on February 13, 2004, Secretary Snow said, in referring to the value of China's currency, "We were straight with them. We said, 'this system doesn't hold together. It doesn't work. It's not right for the world economy. It's not right

for the world trading system and you need to move to a flexible sort of exchange rate that allows the market to set the value rather than having you arbitrarily establish the value.'"

Clearly, these remarks confirm Secretary Snow's and the Administration's recognition of the gross inconsistency between China's foreign-exchange policies and its economic relationship with the rest of the world. In an interview with Charlie Rose broadcast by the Public Broadcasting System on February 25, 2004, Secretary Snow paraphrased his own dialogue with the Chinese government. "'Premier Wen, it's in your interest to move to a flexible exchange rate. You are now becoming a big {sic} big part of the world trading system. And, as part of the world trading system, it's important that you play by the rules of the game – fulfill your WTO commitments, open your markets, deal with this piracy of intellectual property, which is a problem.'" According to Secretary Snow, the Chinese government itself acknowledged these inconsistencies. When asked how the Chinese government reacted to his urgings, Secretary Snow paraphrased its response as follows: "'We intend to be and are and will be a responsible citizen of the globe. We know we are no longer an isolated economy. We are now one of the great economies of the world. We have responsibilities and we're going to live up to them.'"

Later, Secretary Snow testified on March 25, 2004, before the House Committee on Financial Services that "{t}his Administration has stressed that China needs to move to float its currency as soon as possible."[18]

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[18] USTR's 2004 National Trade Estimate Report on Foreign Trade Barriers (April 1, 2004) similarly observes at page 58 that "{t}hroughout 2003, the Administration urged China, both bilaterally and in multilateral fora, to move toward a flexible, market-based exchange rate regime and to reduce controls on capital flows." At the same time, USTR comments that China's new leadership has not announced a timetable to implement a more liberalized, market-oriented currency regime and that "{s}erious engagement with China on this issue will continue in 2004." Id.

While the Treasury Department has taken the lead role on these issues, the extent of the problem has not escaped the White House's attention. In a CNBC interview reported by the British Broadcasting Corporation on September 5, 2003, President George W. Bush said, in a thinly-veiled reference to China, "We expect our trading partners to treat our people fairly -- our producers and workers and farmers and manufacturers -- and we don't think we're being treated fairly when a currency is controlled by the government."

Moreover, in remarks at the Owens Community College outside Toledo, Ohio, as reported in the "Washington Trade Daily" on January 21, 2004, the President made the Administration's position abundantly clear. He bluntly said, "We expect countries like China to understand that trade imbalances mean trade is not balanced and fair. They have got to deal with their currency." Thus, the President has underscored, in no uncertain terms, that a clear link exists between the value of the yuan and the huge U.S. trade deficit with China and that China's manipulation of its currency is harming the U.S. economy.

The opinion of the President and Treasury Secretary Snow is echoed by other policy makers across the political spectrum. The U.S.-China Economic and Security Review Commission, a bi-partisan group mandated by law to examine China's economic policies, recommended as early as October 2003 that:

> The Treasury Department should make a determination in its foreign exchange rate report to Congress that China is engaged in manipulating the rate of exchange between its currency and the U.S. dollar to gain an unfair competitive trade advantage and immediately enter into formal negotiations with the Chinese Government over this matter.[19]

[19] U.S.-China Economic and Security Review Commission, written testimony of Roger W. Robinson, Jr., Chairman, and C. Richard D'Amoto, Vice Chairman, submitted to Hon. Ted Stevens, President Pro Tempore U.S. Senate, and J. Dennis Hastert, Speaker of the House, Oct. 14, 2003.

Even Alan Greenspan, the assiduously non-controversial, previous Chairman of the Federal Reserve Board of the United States, agreed in the summer of 2003 that the yuan was undervalued. See "Transcript: Greenspan on China Foreign Exchange Peg to Dollar," as quoted in The Market Wire, Market News International, July 17, 2003.[20]

More recently, in December 2006 in Beijing during the Strategic Economic Dialogue, Chairman Bernanke noted in a thoughtful, well-reasoned paper,

> As the Chinese trade surplus has continued to widen, many analysts have concluded that the RMB is undervalued. Indeed, the situation has likely worsened recently; because of the RMB's link to the dollar, its trade-weighted effective real exchange rate has fallen about 10 percent over the past five years. Allowing the RMB to strengthen would make imports of consumer goods (as well as capital goods) into China less expensive. Greater scope for market forces to determine the value of the RMB would also reduce an important distortion in the Chinese economy, namely, the effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting rather than producing for the domestic market. A decrease in this effective subsidy would induce more firms to gear production toward the home market, benefiting domestic consumers and firms. Reducing the implicit subsidy to exports could increase long-term financial stability as well: If {sic} China invests too heavily in export industries whose economic viability depends on undervaluation of the exchange rate, a future appreciation of the RMB could lead to excess capacity in those industries, resulting in low returns and an increase in nonperforming loans.

Prepared Text of Remarks by Chairman Ben S. Bernanke at the Chinese Academy of Social Sciences, Beijing, Dec. 15, 2006 (footnotes omitted; emphasis added).

Secretary of the Treasury Paulson has also been emphatic that China needs to take effective measures to revalue the yuan. In testimony before the Senate Banking Committee on

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[20] In response to a follow-up question on whether it would be beneficial to revalue or float the yuan, Greenspan opined, "I think that from an economic point of view it's going to become increasingly evident that is what is going to have to happen . . . ." Id.

January 31, 2007 (transcript at pp. 15-17), Secretary Paulson outlined the steps that in his judgment China must take in order to develop the market infrastructure China needs for a freely floating, market-determined currency and stressed that China is not moving quickly enough in these regards for the United States, the global community, or China's own good.

Congress in particular has expressed growing frustration over the continued undervaluation of the yuan and its resultant negative impact on U.S. jobs, especially in manufacturing. This congressional focus on Chinese undervaluation as a major culprit in continued U.S. job losses is most clearly illustrated by the introduction of numerous bi-partisan bills and resolutions calling for the imposition of broad tariff increases or other restrictions on imports from China. S. 1586 was the first legislation to be introduced during the 108th Congress (on September 5, 2003) in response to China's currency and foreign-exchange policies. While this bill was withdrawn in 2006, it was quickly followed by many others seeking to address China's undervalued and/or manipulated currency, as follows:

Bill/Resolution	**Date Introduced**	**Dated Passed**
S. 1592	September 8, 2003	--
H.R. 3058	September 10, 2003	--
H. Con. Res. 285	September 17, 2003	--
S. Res. 219	September 9, 2003	September 26, 2003
H.R. 3269	October 8, 2003	--
S. 1758	October 20, 2003	--
H.R. 3364	October 21, 2003	--
H. Res. 414	October 29, 2003	October 29, 2003
S. Res. 262	November 6, 2003	--
H.R. 4986	July 22, 2004	--
H. Con. Res. 33	January 26, 2005	--
S. 295	February 3, 2005	--
S.377	February 15, 2005	--
S. Amt. 309 to S.600	April 6, 2005	--
H.R. 1498	April 6, 2005	--
H.R. 1575	April 12, 2005	--
S. 3992	September 28, 2006	--
H.R. 782	January 31, 2007	--
S. 796	March 7, 2007	--

C. China's Exchange-Rate Regime Constitutes Currency Manipulation

On a fundamental level, the value of a nation's currency at any time, as with any other financial asset, is a function of the relative supply and demand for that currency. Also as with any other financial asset, however, the value of a currency does not necessarily reflect its theoretical fair value or equilibrium at any given point in time. In fact, the value of a currency is likely to be above or below its theoretical fair value at any point in time, as the market dynamically searches out equilibrium values through the opposing actions of buyers and sellers, as well as the balancing of the future expectations of market participants.[21] Nevertheless, over time and if permitted, asset values tend to converge toward their fair values or, at a minimum, their market-clearing values. Simply put, when supply exceeds demand for an asset, its price tends to fall, and vice-versa.

Relative prices or values cannot perform their normal, market-clearing function if they are not permitted to fluctuate. By definition, prices or values can remain fixed only if supply and demand are in balance. If prices are not permitted to fluctuate, then differences in supply and demand cannot be mediated, and imbalances between the two will result. In a balance-of-payments context, a country running persistent bilateral trade deficits (such as the United States) will tend to experience depreciation of its currency vis-à-vis the currencies of its trading partners (as the supply of its currency increases in foreign-exchange markets), unless there is an offsetting demand for its currency.

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[21] In fact, it could be argued that given the extent and persistence of the yuan's undervaluation, it might be necessary for the yuan not only to move toward its fair value, but even to move to a comparable degree of overvaluation in order to elicit fully the adjustment in trade and financial flows needed to correct the gross imbalances that China's undervalued currency has helped to generate.

In the case of the United States, the outflow of U.S. dollars through the current account (via the trade deficit) has been offset by inflows through the capital account (via foreign direct investment and portfolio investment), as foreigners return U.S. dollars to the United States by purchasing U.S. real and financial assets. In the case of China, by contrast, current-account inflows (due to its tremendous trade surpluses, especially with the United States) have not been matched by offsetting capital-account outflows (due to extensive Chinese governmental restrictions). In fact, China, like the United States, is also experiencing net capital inflows, as foreign investors have poured money into China seeking higher returns (due in significant part to the undervaluation of the yuan).

Consequently, the situation with China is unusual in that both its current and capital accounts are in surplus, meaning that the supply of foreign exchange in China is increasing. At the same time, as detailed above in Section II.A., the authorized uses of foreign exchange in China are strictly controlled and restricted by the government. Taken together, therefore, the supply of foreign exchange in China's market is increasing at the same time that the uses of (or demand for) foreign exchange are constrained by governmental regulation. Clearly, market forces would dictate that the excess supply of foreign currency in China's market should lead the relative value of foreign currency lower, thereby increasing the value of the yuan. This shift would occur as a result of Chinese market participants converting their foreign-currency holdings (which have limited authorized uses) to yuan (which can be freely used).

The unusual situation in China, with surpluses in both its current and capital accounts, becomes even more anomalous under its foreign-currency regime, which holds the value of the yuan effectively fixed (after relative rates of inflation in China and the United States are considered since the yuan's revaluation on July 21, 2005), at least in relation to the U.S. dollar

(in which China's surpluses are primarily denominated). Thus, the Chinese market for foreign exchange is characterized by excess supply, restricted demand, and essentially a fixed price. In effect, the Chinese government has set the three basic elements of market forces into conflicting and irreconcilable directions, which have, in turn, produced a significant disequilibrium in China's trade and financial flows with the United States. With prices fixed, private market participants have no reason to alter their actions (i.e., relative supply-and-demand preferences), leading to a persistent excess supply of foreign exchange in China's market.

As with any fixed-exchange-rate regime, the Chinese government is able to keep the value of its currency fixed by intervening in the foreign-exchange markets to mediate typically temporary and limited supply-and-demand imbalances as they arise in order to negate pressure on the value of the currency.[22] Once again, the unusual aspect of China's regime is not that the government intervenes in the market, but that the government intervenes in such an extensive, persistent, and one-sided fashion that completely thwarts normal market forces. Rather than act merely as a temporary mediator of supply-and-demand imbalances as fixed-peg regimes require, the Chinese government directly controls supply-and-demand forces, including extensive capital-account controls, while its central bank is, by far, the largest participant in the country's foreign-exchange market. Thus, as the Chinese government oversees ever-growing foreign-exchange surpluses through its mercantilist policies, the central bank must step in to absorb the resulting surpluses, becoming a persistent net buyer of foreign currency, rather than a mere "trader." The end result is a massive increase in China's foreign-exchange reserves that are the end product of

[22] Section II.A. discusses the countries that employ fixed-peg exchange regimes and emphasizes how these countries typically have relatively insignificant or balanced trade flows, in sharp contrast to the situation with China.

what clearly is a carefully orchestrated manipulation of the foreign-currency markets by the Chinese government and monetary authorities.

The general relationship between foreign-currency values (or exchange rates) and official reserve levels reflects the normal workings of this market-equilibrating mechanism, as illustrated in Exhibit 2, Charts 1 and 2. Chart 1 illustrates the relationship between Australia's total foreign exchange reserves and exchange rate, indexed over the period 1990-2006. Chart 2 illustrates the same data for the United Kingdom. Although the indices plotting the trend in foreign-exchange reserves held by these trading partners and their exchange rates vis-à-vis the U.S. dollar are not perfectly congruent, over time exchange rates and foreign-exchange-rate trends adjust to each other for these trading partners, preventing a persistent disequilibrium that would indicate manipulation of the currency for mercantilist advantage.

Exhibit 2, Chart 3 illustrates the corresponding indexed data for China's total reserves compared to its exchange rate to the U.S. dollar. China, whose trade surpluses – both with the United States and the rest of the world – are large, persistent, and growing, has completely interfered with normal market mechanisms, as detailed above. As the chart clearly shows, China's actions have caused a tremendous and still-expanding disequilibrium to develop. The contrast between the reserve/exchange-rate relationship in China and that in Australia or the United Kingdom is so striking that it is impossible to rationalize without looking specifically to the government's interference, i.e., China's policy-oriented orchestration of this desired result.

The intent of these policies is evident in China's accumulation of large and growing U.S. dollar reserves and U.S. government and other dollar-denominated debt instruments. These reserves are greatly in excess of IMF requirements. Despite rapidly increasing foreign-exchange reserves, China's rate of exchange between the yuan and the U.S. dollar has remained virtually

unchanged for extended periods of time, serving artificially to depress the prices of its exports to the United States, while increasing the prices of its imports from the United States, and thereby prejudicing domestic companies whether competing in the United States, China, or other international markets. These repeated and market-contradictory interventions to maintain the increasingly unrealistic value of the yuan vis-à-vis the U.S. dollar are nothing less than an explicit manipulation of China's currency by the Chinese monetary authorities.

D. Chinese Trade Statistics Greatly Understate China's Balance of Trade With the United States As Well As China's Overall Current-Account Surplus

In comparing two countries' bilateral trade data, it must be noted that they rarely agree precisely. Imports by one country will almost never match the exporting partner-country's data. In order to reconcile these differences, trade statisticians commonly use each country's import statistics as a starting point.[23] The significant volume of re-exports through Hong Kong further complicates comparisons between U.S.-China bilateral trade data. In discussing this concern, Chao-Dong Huang and Simon Broadbent observe in their paper, *Trade with China: Do the Figures Add Up?*, "It might be expected that misattribution of exports will be more of a problem than imports, since it is probably easier to determine origin than destination."[24]

China only recently began an attempt to identify the final destination of its goods re-exported through Hong Kong, as many Chinese exports bound for the United States (and other countries) are still not accounted for according to their ultimate destination.[25] A recent study

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[23] In fact, some countries rely on trading partners' import data as a basis for their official export data (i.e., Canada's official exports to the United States are based on official U.S. imports from Canada).

[24] Huang, Chao-Dong and Broadbent, Simon, *Trade with China: Do the Figures Add Up?* National Institute of Economic and Social Research: London, April 1997.

[25] Feenstra, Robert C., et al., *The U.S.-China Bilateral Trade Balance: Its Size and Determinants.* National Bureau of Economic Research, Working Paper 6598 (Cambridge, MA, 1998).

notes that the Chinese Maritime Customs has begun the effort to identify the final destination of goods traveling through Hong Kong, but has had limited success to this point in doing so. Therefore, the study contends, U.S. import data are more reliable than Chinese export data:

> For the Chinese data, it is not clear whether and how much of the re-exports to and from Hong Kong are included.... On the import side, we do know that the U.S. Customs traces the ultimate countries of origin of all imports, including re-exports. Thus, we treat official U.S. data on imports as including both direct and indirect imports, so no adjustments need to be made with respect to the issue of re-exports {of China-origin goods by Hong Kong}.[26]

It can be concluded from the studies cited that partner-country data on imports from China are far more reliable than Chinese data on exports from China, especially given the significant discrepancies between the two, as discussed below.

The demonstrated unreliability in the reporting of trade statistics by China casts uncertainty on any policy decisions based on them, including devising estimates of the extent to which the yuan is undervalued. Trade statistics as published by China – and by China's satellite, Hong Kong – grossly understate China's actual balance-of-trade surplus and, hence, the seriousness of the effects of the yuan's undervaluation.

The analysis below reveals a wide and growing disparity between official Chinese and U.S. data on trade flows between the two countries in recent years.[27] Comparisons show large and increasing differences, especially between China's exports to the United States (according to China) and U.S. imports from China (according to the United States). These discrepancies have

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[26] Fung, K.C. and Lau, Lawrence J., Adjusted Estimates of United States-China Bilateral Trade Balances: 1995-2002, Hiebs Working Paper 1063, April 22, 2003.

[27] The complete analysis, including a methodological discussion, is contained in Exhibit 3. All references to tables and charts in this section, therefore, pertain to Exhibit 3.

increased dramatically in recent years, from $20.7 billion in 1995 to $83.5 billion in 2006.[28] See Exhibit 3, Table 1 and Chart 1. On the U.S.-export/China-import side of the equation, there is also a consistent divergence *in the opposite direction*, with U.S. exports to China (as reported by the United States) trailing the corresponding figures on Chinese imports from the United States (as reported by China). The discrepancy was $3.7 billion in 1995, declined to $2.2 billion in 1998, but then jumped to $9.8 billion in 2004, before declining somewhat to $7.4 billion in 2005 and to $4.6 billion in 2006. See Exhibit 3, Table 1 and Chart 2. With these two sets of trade statistics overall increasingly divergent from one another, the total divergence, or "reliability gap," between the U.S. and Chinese data has widened precipitously, from $24.4 billion in 1995 to $88.1 billion in 2006. A comparison of these data is provided in the table below.

China's Trade Surplus with the United States, 1995 – 2006
By Source, in billion USD

	China Data[29]	U.S. Data[30]	Divergence
1995	9.4	33.8	24.4
1996	11.3	39.4	28.1
1997	17.2	49.5	32.3
1998	21.8	56.9	35.1
1999	23.5	68.9	45.4
2000	30.9	84.2	53.3
2001	29.4	84.1	54.7
2002	44.1	104.2	60.1
2003	60.3	124.9	64.6
2004	82.6	163.6	81.0
2005	116.6	203.8	87.2
2006	147.3	235.4	88.1

[28] There is, of course, a "lag" (typically 4-6 weeks) between the recording of an "export" from the exporting country and the recording of an "import" by the importing country. Such lags, however, would be smoothed out over time; further, any reporting lag cannot begin to explain the large and growing disconnect evident here.

[29] See Exhibit 3, Table 1A.

[30] See Exhibit 3, Table 1B.

As shown, despite the significant understatement evident in the Chinese data, the reported surplus with the United States nonetheless increased more than fifteen-fold from $9.4 billion in 1995 to $147.3 billion in 2006. The corresponding U.S. data show a nearly seven-fold increase in the Chinese surplus over the same period, rising from $33.8 billion in 1995 to $235.4 billion in 2006. In absolute dollar terms, the increase in the surplus over the period between 1995 and 2006 – according to the Chinese government's data – equaled $137.9 billion, which significantly trailed the increase according to the U.S. data, which equaled $201.6 billion. As a result, the divergence between the two sets of data increased by more than $63.7 billion over the period, reaching a peak of $88.1 billion in 2006.

The unreliability of the Chinese government's import and export data also is demonstrated by a comparison of China's trade statistics with the corresponding data reported by the major trading partners accounting for the great bulk of China's trade, by the following method:

For exports *from* China:

- The value of Chinese exports (f.o.b. basis), according to Chinese trade statistics[31]
- The value of imports from China (f.o.b. basis), as reported by 39 partner countries[32]

[31] Some studies have pointed to China's trade with Hong Kong as a source of inaccuracy in the analysis of Chinese foreign-trade statistics, due to the inclusion of trade otherwise properly attributed to China within the exports and imports reported by Hong Kong ("Hong Kong re-exports"). See Exhibit 3, Table 10 for country-specific evaluation of the discrepancy between the reported surplus for each trading partner using China-reported data versus partner-country, mirror trade data. Note that individual partner-country data shown in Exhibit 3, Table 10 are not adjusted for trade through Hong Kong. In the data employed here, Hong Kong's statistics are reported separately from China's, then adjusted to account for these so-called "re-exports" and "re-imports" to and from the mainland. See Exhibit 3, Table 2 (China's adjusted trade with the United States), Exhibit 3, Tables 5 and 6 (China's adjusted trade with partner countries), and Methodological Explanation at pages 1-2.

For imports *into* China:

- The value of Chinese imports (f.o.b. basis), according to Chinese trade statistics[33]
- The value of exports to China (f.o.b. basis), as reported by 39 partner countries

The results of this exercise are similar, but on a correspondingly larger scale, to the results of the bilateral comparison of Chinese and U.S. trade statistics. Overall, use of partner-country data shows that the Chinese government's published data significantly understate exports from China to the world and overstate Chinese imports from the world. Consequently, China's balance-of-trade, according to the Chinese government's data, is distorted from both sides, presenting an increasingly inaccurate and understated total for China's global surplus. As an additional check, the same partner-country data were compiled using the U.N. Comtrade Database.[34] The results confirmed a large discrepancy in the Chinese data and are closely correlated with the Global Trade Atlas database. See Exhibit 3, Table 3, the results of which are summarized as follows:

(...continued)

[32] GTIS Global Trade Atlas, Partner Country Data. Where applicable, import values reported on a c.i.f. basis are deflated by five percent, to approximate values on an f.o.b. basis. For a further explanation of valuation, see Methodological Explanation at pages 3-4. Also, for a list of the 39 partner countries, see Exhibit 3, Table 7.

[33] The value of imports into China is reported on a c.i.f. basis. Therefore, they have been deflated by 5 percent to approximate f.o.b. values.

[34] Exhibit 3, Tables 3 through 6 analyze China's balance of trade by making several different adjustments, as necessitated by the source data, and by using several different sources of data. The different adjustments are reflected in each different table, as follows: Exhibit 3, Table 3 converts any c.i.f. import values to an f.o.b. basis using a 5-percent deflator; Exhibit 3, Table 4 converts any c.i.f. import values to an f.o.b. basis using a 10-percent deflator; Exhibit 3, Table 5 adjusts partner-country data for Hong Kong re-export trade and converts any c.i.f. import values to an f.o.b. basis using a 5-percent deflator; and, Exhibit 3, Table 6 adjusts partner-country data for Hong Kong re-export trade and converts any c.i.f. import values to an f.o.b. basis using a 10-percent deflator.

Moreover, each of the tables contains five subparts, A through E, to reflect the different source data as follows: (A) IMF data; (B) China's data for all countries; (C) China's data for 39 partner countries; (D) 39 partner-country data for China; and, (E) U.N. (Comtrade) data for the 39 partner countries.

China's Global Trade Surplus, 1999 – 2006 *By Source, in billion USD*			
	China Data[35]	39 Partner Data[36]	Percent Divergence
1999	37.7	140.6	273%
2000	35.4	171.6	385%
2001	35.3	169.6	381%
2002	45.1	189.4	319%
2003	46.0	211.2	359%
2004	60.9	285.8	369%
2005	135.1	385.2	185%
2006	217.1	470.1	117%

The large and growing global trade surplus of China, as well as the large and growing discrepancy between China-reported exports and imports and their *converse* – trading-partner imports from and exports to China, respectively – is present whether the data are adjusted by five percent to approximate f.o.b. values or by ten percent, the deflator employed by the IMF.[37]

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[35] See Exhibit 3, Table 3B. The table reflects China's overall trade surplus for all countries, as reported by China. A separate analysis of China's trade surplus with the selected 39 partner countries, as reported by China, is contained in Exhibit 3, Table 3C. See also Exhibit 3, Table 8, which compares the China-reported data for these 39 countries with the China-reported data for all countries.

[36] See Exhibit 3, Table 3D. Note that these 39 partner countries were selected because (1) they account for the bulk of China's total trade (i.e., approximately 90 percent of the total in the period analyzed); and, (2) their corresponding trade statistics are reported on a consistent basis for each year in the period, thereby enabling valid comparisons over time. The data shown in Exhibit 3, Table 3C compare the trade between China and the 39 selected partners, as reported by China, with the corresponding trade with China, as reported by these same countries. See also Exhibit 3, Table 9, which compares the selected partner-reported trade data for China with all partner-reported trade data for China.

[37] See Exhibit 3, Table 4 for adjustments using the 10-percent deflator. A 5-percent adjustment to import values reported on a c.i.f. basis is preferred, because that figure approximates the actual difference between f.o.b. and c.i.f. import data as reported in official U.S. trade data with Asia. See Methodological Explanation at page 4. Even with use of the IMF's 10-percent adjustment, the divergence between China's data and partner-country data ranges between 69 percent in 2006 to 240 percent in 2000. See Exhibit 3, Table 4, comparing Table 4B and Table 4D.

Finally, the China-generated data remain grossly understated compared to partner-country converse data, even if the latter are adjusted to account for so-called Hong Kong re-exports of goods originating on the Mainland. This re-export trade – in which goods are exported from Mainland China to Hong Kong, then re-exported to the rest of the world – has been blamed as the source of much of the discrepancy between Chinese and partner-country trade figures.[38] However, Hong Kong's data that identify the value of total re-export trade – both Hong Kong's exports to and imports from the Mainland – do not explain the data discrepancies, as shown below.

[38] The re-export trade with Hong Kong presents issues of double-counting and misattribution, because China's exports through Hong Kong are reported as both Hong Kong imports from China and partner-country imports from China. See G. Hufbauer and D. Rosen, "American Access to China's Market: The Congressional Vote on PNTR," Institute for International Economics," No. 00-3, April 2000, at 5; but also see K. Bronfenbrenner, et al., "Impact of U.S. – China Trade Relations on Workers, Wages, and Employment," Submitted to the U.S. - China Security Review Commission/U.S. Trade Deficit Review Commission, June 30, 2001. The latter study cites empirical work on the quantity of Hong Kong's re-export trade (both from and to the Mainland) done by the Hong Kong Census and Statistics Office. See also Methodological Explanation at pages 1-3.

China's Global Trade Surplus, Adjusted for Hong Kong Re-Export Trade, 1999 – 2006 *By Source, in billion USD*			
	China Data[39]	39 Partner Data[40]	Percent Divergence[41]
1999	37.7	119.6	217.2%
2000	35.4	148.6	319.8%
2001	35.3	151.6	329.5%
2002	45.1	175.0	288.0%
2003	46.0	203.0	341.3%
2004	60.9	279.2	358.5%
2005	135.1	375.7	178.1%
2006	217.1	464.2	113.8%

In sum, there is a large and growing difference between what China reports as its trade surplus with the world and what China's forty largest trading partners report as China's surplus in their own trade statistics when aggregated. These China-world trade surpluses are becoming more pronounced and show consistent under-reporting by China no matter which one of several calculation methodologies is used. China's own export data are still grossly understated even if adjusted for so-called Hong Kong re-export trade. Based on the selected trading partners' data when adjusted for Hong Kong's re-exports, China's surplus has increased from $119.6 billion in 1999 to $464.2 billion in 2006, an astounding 288-percent increase over just seven years. More importantly, the surplus was roughly three to four times larger than that reported by China over the same period. Notably, the under-reporting by China does not vary significantly when

[39] See Exhibit 3, Table 5B.

[40] See Exhibit 3, Table 5D. Exhibit 3, Table 5 employs the 5-percent c.i.f. deflator and, further, deflates Hong Kong's re-exports to the world by 25 percent and re-exports to China by six percent, to account for mark-ups in Hong Kong on the re-exports, as reported in Bronfenbrenner, et al.; (citing the Hong Kong Census and Statistics Office). Exhibit 3, Table 6 presents these same data using the 10-percent c.i.f. deflator employed by the IMF.

[41] For a full explanation of the methodology used to adjust trade data for Hong Kong's re-export trade, see Methodological Explanation at pages 1-3.

compared to the Chinese data as reported to the IMF. See Exhibit 3, Table 5, comparing Tables 5A and 5D.

Not only is the Chinese government's version of its balance-of-trade at significant odds with its trading partners' data, but these discrepancies are worsening over time. The most salient fact for this analysis is that the Chinese government's balance in each year greatly understates its trade surplus with the rest of the world.

Finally, even when China's surplus with the United States is set aside, the result is a lower worldwide surplus for China – but a large and growing surplus nonetheless.

China's Global Trade Surplus (Excluding U.S. Trade), 1999 – 2006
By source, in billion USD

	China Data[42]	39 Partner Data[43]	Divergence
1999	14.2	71.5	57.3
2000	4.5	87.1	82.6
2001	5.9	85.3	79.4
2002	1.0	84.9	83.9
2003	-14.3	86.0	100.3
2004	-21.7	122.2	143.9
2005	18.5	181.4	162.9
2006	69.9	234.7	164.8

These data show that China's surplus with the rest of the world is growing right along with its even more significant and quickly rising surplus with the United States alone.

As these discrepancies persist and become larger, the fundamental integrity of the Chinese government's data becomes more and more open to question. If the extent of China's large and growing trade surplus were accurately reported, it might go a long way to account for the continuing but otherwise inexplicable "gaping hole" in the global balance-of-payment

[42] See Exhibit 3, Table 3B minus Exhibit 3, Table 1A.

[43] See Exhibit 3, Table 3D minus Exhibit 3, Table 1B.

statistics as reported by the International Monetary Fund. See Ruskin, A., "A Truer Measure of China's Trade Surplus," *The Financial Times*, October 29, 2003.

A series of straightforward conclusions must be drawn from this comparison of China's published foreign trade statistics with the corresponding data compiled by China's trading partners: (1) China's data consistently and egregiously understate its balance-of-trade surplus with the world; (2) the understatements are becoming more pronounced over time; (3) China's data are too unreliable to use as a basis for methodologies estimating undervaluation of the yuan or to evaluate whether China's policies to support the yuan's effective peg to the U.S. dollar constitute currency manipulation; and, (4) as glaring as these discrepancies are, in reality they are even greater, as the data as presented do not take into account the widely-recognized illegal transshipment and false-invoicing of Chinese textiles through Hong Kong, an amount estimated at several billion dollars per year.[44] Inclusion of these data would increase China's surplus and the resultant disconnect even further.

A final conclusion compelled by these discrepancies is vitally important. To this point, the international monetary system's principal policeman, the IMF, appears to have relied on China's trade statistics to assess determinations of whether China manipulates its currency to keep the yuan significantly undervalued. See "IMF Executive Board Concludes 2006 Article IV Consultation with the People's Republic of China." IMF Public Information Notice (PIN) No. 06/103, at 6. Even with the IMF's reliance on China's inaccurate and understated current-account surpluses, the IMF Executive Board commented as follows:

> Many Directors found it appropriate for China to continue to allow greater flexibility in its exchange rate in a gradual and controlled manner. They shared the authorities' concern that accelerating

[44] See Bronfenbrenner, 2001, at 69.

> exchange rate flexibility could have an adverse impact on macroeconomic stability. Some of these Directors also viewed that exchange rate adjustment alone would have a limited impact on external balances. A number of other Directors, however, stressed that the flexibility afforded by the current exchange rate system should be used more extensively. These Directors noted that the current strength of the Chinese economy provides a favorable context for adjustment and should serve to alleviate the authorities' concerns about the potential adverse economic effects. Directors noted that greater exchange rate flexibility, along with other policy changes and reforms in China, will aid in rebalancing the economy over the medium term, and will contribute to the orderly resolution of the global current account imbalance, in conjunction with concerted policy efforts by other key economies.

Id. at 3-4.

The preceding analysis illustrating the unreliability of the Chinese government's trade statistics directly undercuts China's claim that its large and growing trade surpluses with the United States are counter-balanced by trade deficits with the rest of the world. Reliance upon the data showing the true level and trend of China's worldwide trade surpluses leads to the conclusion that China's huge and growing worldwide trade surpluses fulfill the requirements for an affirmative determination of currency manipulation and undervalued-exchange-rate misalignment.

E. Capital Inflows Are Also Increasing, Exacerbating China's Surplus In the Capital Account

As previously discussed, when a country runs a current-account surplus, ordinarily it will generate an offsetting capital-account surplus in order to maintain a balance-of-payments equilibrium.[45] In the case of China, however, both the current- and capital-account surpluses are

[45] The basis of the international monetary system is that countries remain in balance in their overall balance of payments. Thus, a country running a large trade surplus should allow increasing net capital outflows to move toward a total balance-of-payments equilibrium over time. China has for some time, however, pursued policies (such as the undervaluation of the yuan and strict capital controls) that result in growing surpluses in both the current account and (...continued)

large and increasing.[46] This destabilizing situation has been worsening and has become more pronounced with time. As the following table shows, total utilized foreign direct investment ("FDI") into China increased by almost 21 percent between 1994 and 2000, then by 55 percent between 2000 and 2006 as growth accelerated. In 2002, total utilized FDI in China exceeded investment in any other country in Asia, as well as in the United States, for the first time. Moreover, in each year since 2002 the amount of total utilized FDI in China has remained at historically high levels and in 2006 reached a peak of $63.02 billion.

Foreign Direct Investment (FDI) in China
Utilized and Contracted (Billions of U.S. dollars)

Year	Total FDI Contracted	Total Utilized FDI	U.S. Share of Total FDI Contracted	U.S. Share of Total Utilized FDI
1994	82.68	33.77	6.01	2.49
1995	91.28	37.52	7.47	3.08
1996	73.28	41.73	6.92	3.44
1997	51.00	45.26	4.94	3.24
1998	52.10	45.46	6.48	3.90
1999	41.22	40.32	6.02	4.22
2000	62.38	40.72	8.00	4.38
2001	69.19	46.85	7.51	4.86
2002	82.77	52.74	8.20	5.40
2003	115.07	53.51	10.16	4.20
2004	153.47	60.63	12.17	3.94
2005	NA	60.33	NA	3.06
2006	NA	63.02	NA	2.87

Source: China's Ministry of Commerce data as reported by the U.S.-China Business Council

(...continued)
capital account. This large and growing disequilibrium threatens the stability of the global monetary system. A description of the basic equilibrium framework is found in T. O'Herron's Terms of Trade, IAS Publishing, Washington, D.C. 1999, pp. 20, 37.

[46] See Exhibit 4. China's large and growing trade surplus (shown in Exhibit 4 as a global deficit) coupled with China's large and growing foreign-exchange reserves (also illustrated in Exhibit 4) frustrates the natural tendency of the market to reach equilibrium.

These data demonstrate that China's policy of maintaining an undervalued exchange rate has resulted in increased foreign-direct-investment flows even during the period when China's current-account surplus has been increasing. Inflows have increased, especially over the 2000-2006 period, reflecting "bargain-basement" assets in China as valued in the increasingly undervalued Chinese yuan. With China's currency essentially pegged to the U.S. dollar as the U.S. dollar has depreciated against other major currencies, foreign-direct-investment flows into China from other sources have accelerated. The U.S. share of total utilized FDI fell to $2.87 billion in 2006, its lowest level since 1994.

Similarly, contracted foreign direct investment also has increased, particularly since 2000, rising to over $153 billion in 2004 alone, the last full year for which annual data are available.[47] Not only did total contracted foreign direct investment in China grow by 146 percent between 2000 and 2004, but the rate of this increase has been accelerating. The acceleration in contracted foreign direct investment means that foreign-direct-investment flows will continue at least over the next few years.

As discussed in detail in Section II.B.1., above, these increased foreign-direct-investment inflows are an important component in China's overall basic balance-of-payments surplus. With China's basic balance-of-payments surplus increasing, a corresponding surplus of foreign currency arises that normally would be expected to put upward pressure on the yuan. Instead, as noted previously, the Chinese government continuously intervenes in the market to prevent that outcome. This governmental interference maintains the low value of the yuan, which, in turn, provides an artificial support for continued high levels of investment inflows.

[47] It is understood that China's Ministry of Commerce discontinued reporting of total contracted FDI beginning in 2005.

Thus, China's control of its exchange rate has helped spur, and then sustain, foreign-direct-investment inflows, which clearly are of interest to the Chinese government from a policy standpoint. In contrast to the tight controls and outright prohibitions on most other forms of foreign lending and investment in China, foreign direct investment is subject to far fewer restrictions. In addition, the undervalued exchange essentially provides a "discount" for such investment. With the government limiting the ways in which foreigners can invest in China and then providing this "discount," the resulting high level of investment is not surprising.

As is true with many other manifestations of China's undervaluation of the yuan, the initial "success" of the misalignment in this context – spurring foreign direct investment – in turn spawns further undervaluation and misalignment. While China's policy is intended to be self-serving, in the process it distorts the allocation of resources across the globe, embeds or structuralizes imbalanced trade flows and, if permitted to such an extent, ultimately could prove to be destabilizing to China. "China's senior currency regulator warned Thursday {February 26, 2004} that the billions of investment dollars surging into the country may be generating a potentially dangerous bubble...."[48] Along the same lines, the governor of the People's Bank of China was reported as saying that building a market-driven trading system for China's currency is now a "top priority."[49]

The key implication of these data, however, is that the volume of foreign direct investment in China has been sufficient by itself to support or trigger a revaluation in the yuan. With annual inflows increasing to more than $60 billion, FDI now represents approximately 2 to 3 percent of China's GDP. Thus, even if the other component in China's basic imbalance – its

[48] Id.

[49] Richard McGregor, "China Shifts Rhetoric on Renminbi Trading System," Shanghai Financial Times, Apr. 19, 2004.

burgeoning trade-driven, current-account surplus -- were somehow brought back to balance, the sustained level of high foreign-investment inflows is sufficient in its own right to keep upward pressure on the yuan and, therefore, provide a continuing basis and need for the Chinese government's intervention in the market.

F. China's Currency Regime Poses A Threat to the International Financial System

China's policy of maintaining an undervalued-exchange-rate system is creating financial instability that will eventually disrupt global financial markets unless China appreciates its currency in line with underlying economic fundamentals. The threat to the international financial system is exacerbated by the size of China's economy, China's volume of global trade, and the amount of foreign-direct-investment commitments and flows into China. China's accelerating accumulation of foreign-exchange reserves is creating disequilibrium in the international financial system, will tend to cause inflation and over-investment in China, and will lead to the conditions for another international financial crisis.

As described in detail in Exhibit 1, under its fixed-exchange-rate system with tight capital controls, China has sacrificed its fuller integration into the world economy and monetary independence in favor of exchange-rate stability. The inappropriateness of this exchange-rate regime is perhaps best illustrated by the enormous lengths to which the Chinese government must extend its interference in the market in order to achieve these monetary policy goals. Moreover, China's adherence to these goals -- no matter what their cost or how superficially they are achieved -- is even more revealing.

The type of closely controlled exchange regime employed by China ordinarily is confined to countries with relatively minor and/or balanced trade and investment flows with the rest of the world. This situation is due to the fact that large and imbalanced flows can quickly overwhelm

such a closely-controlled system, although this danger has yet to prove a deterrent to China. In its dogged pursuit of exchange-rate stability, the Chinese government has had to intervene to purchase ever-greater volumes of foreign exchange (especially U.S. dollars) each year. Nevertheless, while these purchases have succeeded in keeping the yuan's value stable against the U.S. dollar, they completely run counter to the trend in the rest of the world, where the U.S. dollar generally has fallen significantly in value. Thus, when the U.S. dollar fluctuates against other foreign currencies, China's achievement of exchange-rate stability with the U.S. dollar directly undermines achievement of exchange-rate stability with respect to all other currencies that float against the U.S. dollar. In other words, the actual exchange-rate stability achieved is limited to the U.S. dollar. By virtue of achieving stability with the U.S. dollar, China faces potentially less stability with respect to other currencies.

The other policy goal of monetary independence likewise is undermined by China's maintaining an essentially fixed exchange rate in the face of such large imbalances in its trade and investment flows. As discussed generally in Section II and Exhibit 1, rather than permit the yuan to increase in value, the Chinese government has chosen instead to offer any amount of yuan needed to absorb any supply of foreign currency. Consequently, as shown in the next table, as larger and larger foreign-currency surpluses have flowed into the Chinese market, the government has had to flood the market with more and more yuan. Thus, if China wishes to maintain exchange-rate stability in the face of such foreign-currency inflows, it does so at the cost of its control over its domestic money supply. Along with this rapid growth in the money supply, however, there is increasing evidence that the Chinese government has fostered a speculative over-investment boom and the foundation for much higher inflation in the future. If

not corrected, these trends will coalesce in an unstable bubble that, due to the size of China's economy and volume of trade, will adversely affect international trade and financial markets.

Money Supply
(Billion Yuan)

	2000	2001	2002	2003	2004	2005	2006
Money	5,454	6,168	7,088	8,412	9,582	10,690	12,604
% increase	--	13.1%	14.9%	18.7%	13.9%	11.6%	17.9%
Quasi Money	8,142	9,472	11,412	13,710	15,724	19,148	22,006
% increase	--	16.3%	20.5%	20.1%	14.7%	21.8%	14.9%

Source: IMF International Financial Statistics

As previously discussed, China's undervalued-exchange-rate policy discriminates against U.S. exports of goods and services. By maintaining an undervalued exchange rate against the U.S. dollar, China discriminates against U.S. products to China's benefit. Prices of Chinese goods and services in the U.S. market are lower than what would prevail under an exchange rate that reflected underlying economic fundamentals. Conversely, U.S. products in China are priced higher than what would prevail with an exchange rate that reflected underlying economic fundamentals. In addition, the yuan's undervalued exchange rate discriminates against other IMF countries. As the U.S. dollar depreciates against other currencies, the exchange rate with China does not change, and the advantage that China has through its undervalued exchange rate remains the same. Other currencies adjust simultaneously to the yuan and the U.S. dollar because the exchange rate is essentially fixed, but those currency adjustments must be greater than what would be required under market conditions because the yuan is significantly undervalued and unable to appreciate against the dollar.

While China's undervalued exchange rate clearly discriminates against the United States and other IMF members, judging from the results of Article IV consultations, this discriminatory currency practice has not been authorized by the Fund. The Article IV consultations that were made public in 2000 concluded, "... Directors suggested that the authorities move ahead gradually with a more flexible implementation of the current arrangements, involving the widening of the trading band around a reference rate based on a basket of currencies." As remarked above in Section II.D, the IMF's Executive Board made much the same observation, with perhaps somewhat greater impatience expressed with China, in the context of the 2006 Article IV Consultation. Nevertheless, even after the modest revaluation in July 2005, China has maintained an effective peg of the yuan to the U.S. dollar in real terms.

G. Summary

As the foregoing statistical evaluation and assessment delineate, China's undervaluation and manipulation of the yuan are unequaled by the currency policies of the other nations of the world. In terms of the extensiveness of its controls and intervention in the market and the deleterious consequences for the global economy, China's exchange-rate regime is the antithesis of an open, mutually beneficial, and market-driven international system.

III. CONTRARY TO SECTION 301(a) OF THE TRADE ACT OF 1974, CHINA'S MAINTENANCE OF AN UNDERVALUED-EXCHANGE-RATE REGIME VIOLATES CHINA'S OBLIGATIONS AND DENIES THE UNITED STATES RIGHTS AND BENEFITS TO WHICH THE UNITED STATES IS ENTITLED UNDER INTERNATIONAL LAW

A. China's Maintenance of An Undervalued-Exchange-Rate Regime Is In Breach of Basic Principles of the World Trade Organization and Its Agreements

1. Background

Since entry into force of the General Agreement on Tariffs and Trade in 1947 ("GATT"),[50] the global trading system has been structured to minimize and, to the extent possible, avoid mercantilism and "beggar-thy-neighbor" policies by the nations of the world against each other. Underlying this international economic structure has been the widely shared conviction that all countries stand to gain as tariff and non-tariff barriers to international trade are reduced.

As set forth in Section II above, China's misalignment of the yuan presents an exceptional and unique instance of currency undervaluation and manipulation.[51] The World Trade Organization ("WTO") and the global trading system cannot afford to have this manipulative undervaluation continue. In ways both stark and sometimes subtle but no less damaging, China's undervalued-exchange-rate regime is seriously weakening the rules-based

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[50] General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194.

[51] When a country pegs its currency to another country's currency and does not make adjustments for severe market fluctuations, its currency maintains a value that is different from that which would result from natural market forces. This phenomenon is called currency manipulation, which is a form of discriminatory currency arrangement. Sir Joseph Gold defines discriminatory currency arrangements as "arrangements by a member to discriminate through its exchange system for the benefit, or to the detriment, of another member or members." See Sir Joseph Gold, Exchange Rates in International Law and Organizations 252, 281 (ABA Sec. of Int'l Law and Practice 1988).

international trading system and has already caused and will only lead in the future to further economic deterioration globally and in the U.S. economy, in particular, if allowed to continue.

2. China's Maintenance of An Undervalued-Exchange-Rate Regime Is A Prohibited Export Subsidy That Violates Articles 1 and 3 of the WTO Agreement on Subsidies and Countervailing Measures, Articles VI and XVI of the GATT, and China's WTO Obligations Concerning Agricultural Products

a. Overview

China's maintenance of an undervalued-exchange-rate regime constitutes a prohibited de facto export subsidy within the meaning of Articles 1, 2, and 3 of the WTO Subsidies and Countervailing Measures Agreement ("SCM Agreement"), Articles VI and XVI of the GATT, and China's WTO obligations concerning agricultural products. This prohibited export-subsidy scheme is unjustifiable, it burdens and restricts United States commerce, and it denies and violates the United States' rights under WTO Agreements.

Export subsidies like China's currency-undervaluation regime are so disfavored in international law that they are prohibited by the WTO Agreements, particularly Article 3 of the SCM Agreement. As Ambassador Zoellick stated in his January 11, 2004 letter to WTO trade ministers, "Export subsidies distort trade more than any other measure." While he was referring in that instance to agricultural export subsidies, the principle applies to all export subsidies, which are viewed as the most damaging form of subsidy. Moreover, China's undervalued-exchange-rate-misalignment regime is an export subsidy that benefits each and every export sale of a Chinese product to the United States to a substantial degree, which likely makes it the largest, or one of the largest, impermissible export-subsidy programs ever provided.

Export subsidies are viewed as indefensible due to their "beggar-thy-neighbor" nature, and the WTO Agreements accordingly go so far as to require that remedies for prohibited export subsidies be implemented on an expedited basis under Article 4 of the SCM Agreement.

Moreover, such subsidies are essentially the only trade practice with a WTO-sanctioned remedy that is not restricted by the trade effects caused by the measure implemented.

While undervalued-exchange-rate-misalignment subsidies have infrequently been the subject of dispute settlements under the GATT, both the GATT and the current WTO Agreements explicitly and repeatedly recognize that certain currency practices violate common subsidy disciplines. China's undervalued, effectively fixed-exchange-rate regime manifests the essential features of an unfair subsidy practice by virtue of involving governmental action to:

(1) maintain an essentially fixed exchange rate on current accounts;

(2) impose non-convertibility of capital accounts;

(3) direct massive bank purchases of U.S. dollars; and

(4) utilize other measures described in other sections of this petition to maintain its undervalued-fixed-exchange-rate regime.

These measures by China encourage massive and increasing exports to the United States from China of unfairly low-priced manufactured and agricultural goods beyond levels that would occur absent these policies in a rational, market-based system under current economic conditions. As demonstrated below, China's undervalued-exchange-rate scheme satisfies each of the elements required to show the existence of a prohibited export subsidy. As such, in accord with Article 3.2 of the SCM Agreement, China, as a WTO Member, must eliminate this subsidy program.

b. China's Undervalued-Exchange-Rate Regime Is Proscribed Under the SCM Agreement and GATT Articles VI and XVI

The following paragraphs demonstrate that: (1) export subsidies are prohibited by the SCM Agreement and GATT Articles VI and XVI; (2) undervalued-exchange-rate misalignment is contemplated by the SCM Agreement as a prohibited export subsidy in certain situations; (3) China is not exempt from prohibitions on export subsidies; (4) China's undervalued-exchange-

rate regime satisfies all of the prerequisites under Articles 1, 2, and 3 of the SCM Agreement and consequently is an unlawful export subsidy; and (5) the conclusion that China's undervalued-exchange-rate regime is a proscribed export subsidy is underscored by the fact that several of the tools or programs that are employed by the Chinese government and that undermine the yuan's value are identified by the SCM Agreement's Illustrative List separately as prohibited export subsidies.

i. Export Subsidies Are Prohibited Under the SCM Agreement and Articles VI and XVI of the GATT

From its origin in 1947, the GATT and its related Agreements have recognized and worked to prohibit the trade-distorting nature of subsidy programs designed to support and artificially facilitate exports from one Contracting Party or Member State to another.[52] Article XVI of the GATT specifically recognizes that export subsidies ". . . may cause undue disturbance to . . . normal commercial interests, and may hinder the achievement of the objectives of this Agreement." See GATT, Article XVI:2 (emphasis added).

Article XVI goes on to provide that "as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." Article XVI:4 (emphasis added). GATT Article VI acknowledges that export subsidies may also be subject to countervailing duties. A number of

[52] The WTO Agreements constitute a single treaty that is to be interpreted so as to permit the GATT's provisions and the WTO Agreements to coexist. See Appellate Body Report, Korea -- Definitive Safeguard Measure on Imports of Certain Dairy Products, adopted Jan. 12, 2000, WT/DS98/AB/R, para. 75 (applying this concept to GATT Article XIX and the WTO Safeguards Agreement).

decisions in dispute settlements under the GATT further illustrate the disfavor in which export subsidies have been, and continue to be, held.[53]

The SCM Agreement amplifies upon and extends the GATT's provisions on subsidies and substantially strengthens the disciplines covering export subsidies, first, by explicitly prohibiting such subsidies under Article 3 of the SCM Agreement. Article 3.2 of the SCM Agreement states succinctly that WTO Member States "shall neither grant nor maintain" prohibited export subsidies.[54] As indicated in the Appellate Body's report in United States -- Foreign Sales Corporation,

> In fact, as we have observed previously, the *SCM Agreement* contains a broad package of new export subsidy disciplines that 'go well beyond merely applying and interpreting Articles VI, XVI and XXIII of the GATT 1947.' . . . {T}he *SCM Agreement* establishes a much broader prohibition against *any* subsidy which is 'contingent upon export performance.' To say the least, the rule contained in Article 3.1(a) of the *SCM Agreement* that all subsidies which are 'contingent upon export performance' are prohibited is significantly different from a rule that prohibits only those subsidies which result in a lower price for the exported product than the comparable price for that product when sold in the domestic market.[55]

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[53] See, e.g., Appellate Body Report, EEC -- Subsidies on Export of Wheat Flour, SCM/42, Mar. 21, 1983, unadopted, paras 5.5-5.7, cited in MTN.GNG/NG10/W/3 (Mar. 17, 1987).

[54] While this petition focuses in the first instance on the export-oriented nature of the subsidy provided, China's measures resulting in a protracted undervaluation of its currency can also be seen as a scheme that functions "in fact" as an import-substitution program prohibited by SCM Articles 3.1(b) and 3.2 and by Article III of the GATT 1994. The currency scheme artificially overvalues imported goods and undervalues domestic goods, resulting in a subsidy "in fact" to domestic goods relative to imported goods. See Appellate Body Report, Canada – Certain Measures Affecting the Automotive Industry, adopted June 19, 2000, WT/DS139/AB/R, WT/DS142/AB/R, paras. 135-146.

[55] Appellate Body Report, United States – Tax Treatment For "Foreign Sales Corporations," adopted Mar. 20, 2000, WT/DS108/AB/R, para. 117 (citation omitted) (italics in original).

In its first Annex, the SCM Agreement also includes an "Illustrative List" that provides examples of certain types of prohibited export subsidies. Although this list is long, it is simply illustrative of prohibited export subsidies -- it is not comprehensive. In fact, the list contemplates the existence of other programs that function as export subsidies in addition to those listed, as exemplified in its final "basket" category, which sweeps in as prohibited export subsidies "{a}ny other charge on the public account constituting an export subsidy in the sense of Article XVI of GATT 1994." See SCM Agreement at Annex I.

ii. Certain Forms of Currency Undervaluation Violate the SCM Agreement and Article VI of the GATT

From the beginning, the GATT has confronted and addressed concerns that various types of foreign-exchange subsidy programs violate the GATT's subsidy disciplines. For example, the addenda to Articles VI:2 and VI:3 of the GATT state that "{m}ultiple currency practices can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties . . . . By 'multiple currency practices' is meant practices by governments or sanctioned by governments." GATT, Ad. Article VI, paras. 2-3, note 2 (emphasis added). In the same vein, a 1960 GATT report under Article XVI:5 stated that " . . . there was a clear obligation to notify to the CONTRACTING PARTIES multiple exchange rates which have the effect of a subsidy."[56] Thus, currency subsidies that include the required elements to find an export subsidy are impermissible or actionable. In this case, because the subsidy is so closely tied in design and action to act as an export subsidy, particularly with regard to exports to the United States, the subsidy is prohibited by GATT and the WTO SCM Agreement.

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[56] See Panel Report, Review Pursuant to Article XVI:5, L/1160, adopted May 24, 1960, BISD 9S/188, 192, para. 13.

Furthermore, the SCM Agreement's "Illustrative List of Export Subsidies" mentions certain prohibited export subsidies that involve foreign-exchange programs and related credit programs that could potentially affect foreign-currency exchange issues. See SCM Agreement at Annex I. Such practices include "currency retention schemes" (item b)[57] and programs that cover the long-term operating costs and losses of foreign-exchange programs (item j).[58] Thus, the SCM Agreement and Article VI of the GATT clearly contemplate that foreign-exchange mechanisms can be manipulated to provide subsidies, particularly to exports, the latter aspect of which is not surprising given the close nexus between the use of exchange rates and export activities.

iii. China Does Not Qualify for Any Exception to the Prohibition in Article 3 of the SCM Agreement on the Use of Export Subsidies

A few, very limited exceptions exist to the rule prohibiting export subsidies, but China's written commitment to eliminate export subsidies (expressed repeatedly during its WTO accession process) makes it ineligible for these exceptions. Moreover, China would not qualify for these exceptions even if it had not declared itself ineligible for them during the accession process.

Article 27 of the SCM Agreement, for example, carves out limited exceptions to the prohibition on export subsidies for certain developing country members. Under Article 27.2(a) and Annex VII of the SCM Agreement, certain listed developing-country members are exempt

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[57] "Currency retention schemes or any similar practices which involve a bonus on exports." SCM Agreement at Annex I(b).

[58] "The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes." SCM Agreement at Annex I(j). Item (j) is discussed in more detail below.

from the prohibition on export subsidies in Article 3.1(a), and other countries were exempted from that provision for a period of eight years from the date of entry into force of the WTO Agreement. Under Article 27.3 of the SCM Agreement, the provisions of Article 3.1(b) did not apply to developing countries and least-developed countries for five and eight years, respectively, from the WTO Agreement's entry into force.

During the negotiations leading up to its accession to the WTO, China explicitly stated that it only reserved the right to benefit from four provisions of Article 27, none of which involves an exception to the prohibition on export subsidies.[59] China reserved the right to benefit from Article 27 subsections 27.10, 27.11, 27.12 and 27.15. The first three of these provisions pertain to findings of de minimis subsidies in countervailing duty proceedings, while Article 27.15 allows an interested developing-country Member State to request the WTO's SCM Committee to review and examine whether a specific countervailing duty measure is consistent with Articles 27.10 and 27.11 as applicable to that developing-country Member State.[60]

Most important, as recorded in the Report of the Working Party on the Accession of China, China committed to --

> eliminate all export subsidies, within the meaning of Article 3.1(a) of the SCM Agreement, by the time of accession. To this end, China would, by accession, cease to maintain all pre-existing export subsidy programmes and, upon accession, make no further payments or disbursements, nor forgo revenue, or confer any other benefit, under such programmes. This commitment covered

[59] See Report of the Working Party on the Accession of China, WT/ACC/CHN49, at 33-35 (Oct. 1, 2001).

[60] The SCM Agreement contains two additional exceptions to the export-subsidy provisions under Articles 28 and 29, but neither applies here because China committed to eliminate export subsidies entirely. Moreover, both provisions include subsidy "notice" provisions and so implicitly reference Article 25, the section of the SCM Agreement that deals with notifications of subsidies by each Member State to the WTO. China, however, has not given any such notifications regarding its currency-subsidy regime.

> subsidies granted at all levels of government which were contingent, in law or in fact, upon an obligation to export.

WT/ACC/CHN/49, at 33. The Chinese government also ". . . confirmed that China would eliminate, upon accession, all subsidies contingent upon the use of domestic over imported goods, within the meaning of Article 3.1(b) of the SCM Agreement." Id.

China's final Accession Protocol reflects these commitments:

> 10. Subsidies
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> 1. China shall notify the WTO of any subsidy within the meaning of Article 1 of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement"), granted or maintained in its territory, organized by specific product, including those subsidies defined in Article 3 of the SCM Agreement. The information provided should be as specific as possible, following the requirements of the questionnaire on subsidies as noted in Article 25 of the SCM Agreement.
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> * * *
>
> 3. China shall eliminate all subsidy programmes falling within the scope of Article 3 of the SCM Agreement upon accession.

Accession of The People's Republic of China, Decision of 10 November 2001, WT/L/432 (23 November 2001).[61] China's accession to the WTO Agreements occurred on December 11, 2001.

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[61] In addition to failing to eliminate its export-subsidy program on foreign exchange, it is useful to understand that China is involved in a series of other subsidy practices that demonstrate its disregard for its WTO accession commitments and compliance with other WTO subsidy disciplines. For example, the WTO's second review in late 2003 of China's accession and membership in the WTO indicated that the Chinese tax system offers incentives contingent upon export volumes that exceed established thresholds. The WTO's review concluded that this arrangement is a violation by China of Article 3 of the SCM Agreement and Section 10 of China's Accession Protocol. See Protocol on the Accession of the People's Republic of China, WT/L/432, Section 10 at para. 3 (China WTO Accession Protocol); Chair's Report to the Council for Trade in Goods on the Transitional Review of China, G/SCM/111, paras. 9, 38, 41, 44 (Nov. 18, 2003) (Second Transitional Review). China also was found to have continued subsidies to state-owned enterprises despite having explicitly committed to discontinue such subsidies. Second Transitional Review at 9, 38, 41, 44; China WTO Accession Protocol at (...continued)

As a prohibited export subsidy under Article VI of the GATT, this currency scheme must be eliminated by the Chinese government. Moreover, as next described, Articles 1, 2, and 3 of the SCM Agreement underscore that China's undervaluation of the yuan is a prohibited export subsidy.

iv. China's Maintenance of An Undervalued-Exchange-Rate Regime Meets All of the Pertinent Criteria Under Articles 1, 2, and 3 of the SCM Agreement and Consequently Is An Unlawful Export Subsidy

The Chinese government's undervalued-exchange-rate misalignment constitutes an impermissible export subsidy under Articles 1.1, 1.2, 2.3, and 3 of the SCM Agreement, because the program involves a governmental financial contribution, bestows a benefit upon the recipients, and is specific due to being export-contingent.

(...continued)
Annex 5B. Moreover, in April 2006, China belatedly submitted the first of what are required to be annual notifications of its subsidies under Article 25 of the SCM Agreement. Despite its title by China, Subsidies – New and Full Notification Pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the SCM Agreement, People's Republic of China, G/SCM/N/123/CHN (Apr. 13, 2006), this notification did not notify all of the Chinese central government's subsidy programs and did not notify any subsidies provided at the sub-central governmental level. See Questions from the United States Regarding the New and Full Notification of China, G/SCM/Q2/CHN/19 at 1 (July 26, 2006). Insofar as is known at present, China has responded neither to these questions by the United States in July 2006 nor to a first set of questions posed by the United States in October 2004 regarding China's subsidy programs. See, e.g., Subsidies Enforcement Annual Report to Congress, Joint Report of the Office of the United States Trade Representative and the U.S. Department of Commerce at 19-22 (Feb. 2007). In February 2007, the United States formally initiated dispute settlement at the WTO by seeking consultations with China with respect to certain subsidies by China viewed by the United States as prohibited export subsidies under Article 3 of the SCM Agreement. China – Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments, WT/DS358 (Feb. 2, 2007). This request for consultations at the WTO was refiled by the United States on April 27, 2007, in order to reflect possible subsidies in a new Chinese law and also to take account of China's decision in the interim to remove one of the subsidies identified in the February request for consultations. See China – Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments, Request for Further Consultations by the United States, Addendum, WT/DS358/1/Add.1 (May 2, 2007). If no mutually satisfactory resolution emerges from the consultations after sixty days by late June 2007, the United States at that juncture will be free to go ahead with dispute settlement.

(a) Governmental Financial Contribution

As relevant, Article 1.1 of the SCM Agreement indicates that a subsidy exists if there is a direct or potential direct financial contribution by a government (or an intermediary), where governmental revenue that is otherwise due is foregone or not collected, the government provides goods or services other than general infrastructure, or the government makes payments to a funding mechanism, and a benefit is thereby conferred. See SCM Agreement, Article 1.1.[62] Very importantly, governmental financial contributions are not limited to the direct provision of

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[62] Article 1.1 of the SCM Agreement reads:

Article 1

Definition of a Subsidy

1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:

(i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);

(iii) a government provides goods or services other than general infrastructure, or purchases goods;

(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;

or

(...continued)

funds, but include as well indirect payments and measures that have an effect that is equivalent to that of a direct payment.[63] Thus, an undervalued-exchange-rate program that directly or indirectly provides financial contributions or services will qualify as a subsidy if the other elements of the subsidy test also are satisfied.

The Chinese government's foreign-exchange scheme provides to Chinese exporters and their exports to the United States a financial contribution within the meaning of the SCM Agreement. The Chinese government requires its citizens to exchange their dollars for local currency, sets the rate of exchange by fiat, and prints the money to fund the transaction. By directing the conversion of U.S. dollars at an extremely undervalued rate, the Chinese government provides a financial contribution and service within the meaning of Article 1.1(a)(1)(iii) of the SCM Agreement.[64] China's management of this exchange-rate process in this manner encourages increased exports to the United States by Chinese manufacturers and

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(...continued)

(a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994;

and

(b) a benefit is thereby conferred.

SCM Agreement, Article 1.1 (footnote omitted).

[63] See, e.g., Panel Report, Brazil – Export Financing Programme for Aircraft, decided Apr. 14, 1999, WT/DS46/R, adopted as modified by Appellate Body Report, Aug. 20, 1999, para. 7.68 (when a governmental action gives rise to a benefit, a subsidy is conferred irrespective of whether any payment occurs); Second Report on Anti-Dumping and Countervailing Duties, L/1141, adopted May 27, 1960, BISD 9S/194, 200, para. 34 (stating that "{i}t was agreed that the word 'subsidies' covered not only actual payments, but also measures having an equivalent effect.").

[64] To the extent that the Chinese government entrusts or directs any private bodies to assist in effectuating the yuan's undervaluation, which assistance appears also to take place, the conclusion still holds under Article 1.1(a)(1)(iv) that the Chinese government is providing a financial contribution and service as defined by the SCM Agreement.

increases employment for Chinese workers at the expense of U.S. manufacturers and U.S. workers.

More specifically, China's maintenance of the effectively pegged-exchange rate and the severe undervaluation of the yuan have made Chinese products increasingly attractive and more affordable in the United States and in other foreign markets by giving the U.S. dollar a purchasing power far greater versus the yuan than what normal commercial forces would dictate. Chinese exporters accordingly can sell for export increased volumes and earn additional returns in yuan that would not be the case if the yuan were not governmentally undervalued.

China's undervalued-exchange-rate misalignment further contributes financially to Chinese exports to the United States by shielding Chinese exporters from expenses involved with hedging against significant foreign-exchange losses or purchasing guarantees to guard against exchange-rate fluctuations. These costs are avoided thanks to the Chinese government's guarantee of a substantially undervalued, effectively pegged-exchange rate that prevents any real and sizeable fluctuations between the yuan and the U.S. dollar. This same established undervaluation generates other financial contributions indirectly by saving time and effort otherwise for Chinese exporters in conducting their exporting operations.

(b) Benefit

Under Article 1.1(b) of the SCM Agreement, a benefit is provided by these financial contributions because the Chinese government's policy and practice of devaluing the yuan make "the recipient 'better off' than it would otherwise have been, absent that contribution." See Appellate Body Report, Canada -- Measures Affecting the Export of Civilian Aircraft, adopted Aug. 20, 1999, WT/DS70/AB/R, para. 157 ("Canada – Aircraft") ; see also Panel Report, United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom, adopted June 7, 2000, WT/DS138/R, at paras.

6.66-6.69 (stating that "{t}he existence or non-existence of 'benefit' rests on whether the potential recipient or beneficiary . . . received a 'financial contribution' on terms more favourable than those available to the potential recipient or beneficiary in the market.").

Given that China does not permit its foreign-exchange rate to be set by market forces, the probable free-market value of the yuan is an acceptable benchmark for the purpose of evaluating the benefit of China's currency manipulation. This methodology was endorsed in Canada -- Civil Aircraft, which states that "{i}n our view, the marketplace provides an appropriate basis for comparison in determining whether a 'benefit' has been 'conferred', because the trade-distorting potential of a 'financial contribution' can be identified by determining whether the recipient has received a 'financial contribution' on terms more favourable than those available to the recipient in the market." Canada -- Aircraft, WT/DS70/AB/R, para. 157. The Appellate Body added that "Article 14, which we have said is relevant context in interpreting Article 1.1(b), supports our view that the marketplace is an appropriate basis for comparison." Id.

Thus, there is no doubt that, under these terms, Chinese exporters and exports receive a primary benefit from China's essentially pegged-exchange rate of the considerable difference between the governmentally-controlled exchange rate and the rate that would prevail under a market-exchange system for the yuan. In addition, Chinese exporters and exports receive secondary benefits by way of reduced transaction costs stemming from the absence of a significantly fluctuating foreign-exchange market and foreign-exchange risks. Within the meaning of Article 1.1(b) of the SCM Agreement, therefore, these primary and secondary benefits certainly leave China's exporters and exports in a far better position than if the yuan were not so severely undervalued.

(c) Specificity

Under Article 1.2 of the SCM Agreement, a subsidy as defined in Article 1.1 is subject to the provisions of Part II of the SCM Agreement if that subsidy is "specific" in accordance with Article 2 of the SCM Agreement. In turn, Article 2.3 states that "{a}ny subsidy falling under the provisions of Article 3 shall be deemed to be specific," while Part II in Article 3 of the SCM Agreement, as relevant, prohibits subsidies that are contingent, in law or in fact, upon export performance.[65]

China's undervalued exchange-rate regime is specific and properly classified as a prohibited export subsidy under the foregoing provisions of the SCM Agreement for a number of compelling reasons.[66] First and foremost, as just observed, Article 3 of the SCM Agreement

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[65] Article 3: Prohibition

3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

(a) subsidies contingent, in law or in fact[4], whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I[5];

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[4] This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

[5] Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.

(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph 1.

[66] As indicated earlier, the SCM Agreement's Illustrative List is not an exclusive listing of export subsidies, but merely provides examples of certain types of prohibited export subsidies. Simply because a particular subsidy program is not explicitly identified in Annex I does not mean the program is not an export subsidy. To argue otherwise would be to make Article 3 of the SCM Agreement redundant and meaningless, which it is not.

prohibits subsidies that are contingent, in law or in fact, upon export performance. Petitioners do not contend that the Chinese government's subsidy program described here is explicitly contingent in law on export performance. Petitioners do contend and demonstrate below, however, that this program is "in fact tied to actual or anticipated exportation or export earnings." See SCM Agreement, Article 3.1(a) n.4.[67] In other words, while China has not expressly stated in its laws that its undervalued exchange-rate regime is designed to increase exports to the United States in an effort to bolster Chinese manufacturing capabilities and increase China's employment levels and U.S.-dollar holdings, in fact the policy actually does accomplish these goals.

To determine whether a subsidy is de facto contingent upon export performance requires an analysis of the facts of the subsidy and the nature of its tie to export promotion. The Appellate Body articulated the required inquiry in one case as follows:

> . . . the existence of this relationship of contingency, between the subsidy and export performance, must be *inferred* from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case.
>
> Recognizing the difficulties inherent in demonstrating *de facto* export contingency, the Uruguay Round negotiators provided a standard, in footnote 4 of the *SCM Agreement*, for determining when a subsidy is "contingent . . . in fact . . . upon export performance.

Canada -- Aircraft, WT/DS70/AB/R, paras. 167-168 (emphasis in the original). As cited previously, footnote 4 to Article 3 of the SCM Agreement directs that the standard for ascertaining that a subsidy is contingent in fact upon export performance

[67] Petitioners do not allege that the mere fact that a subsidy is granted to enterprises that export for that reason alone classifies China's undervaluation of the yuan as a prohibited export subsidy under Article 3.

> . . . *is met* when the *facts demonstrate* that the *granting* of a subsidy, without having been made legally contingent upon export performance, is *in fact tied to actual or anticipated exportation or export earnings*. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

Canada -- Aircraft, WT/DS70/AB/R, para. 168 (emphasis in the original). Toward this end, evaluation of whether a subsidy is contingent, in fact, upon export performance must examine three elements: (1) whether the granting authority has imposed a condition based on export performance in providing the subsidy; (2) whether the facts demonstrate that the granting of a subsidy is tied to or contingent upon actual or anticipated exports; and (3) whether, as one relevant fact among others analyzed, the subsidy recipient is export-oriented. See Canada -- Aircraft, WT/DS70/AB/R, paras. 170-173.

The application of these factors to China's foreign-exchange policy and practice confirms that China's undervalued-exchange-rate regime constitutes a de facto export subsidy. First, the Chinese government, as the granting authority, imposes a condition based on export performance in providing the subsidy. The subsidy, derived from the undervalued yuan, is dependent upon the existence of export performance in order to take effect. The nexus between the subsidy of the yuan's exceptional undervaluation and the prerequisite of exportation for a company in China to enjoy that subsidy is so close and inextricably linked that conditionality is indisputable.

Second, the facts demonstrate that the granting of the subsidy is tied to or contingent upon actual or anticipated exports from China, because the subsidization would not occur if exports did not occur. In order for the foreign-exchange program to operate, products must be traded internationally. Without export performance, there would be no foreign currency to exchange. Moreover, the fact that the subsidy results in increased exports to the United States

and elsewhere and in the accumulation by China of massive foreign-exchange reserves provides additional evidence of tying. Thus, the required tying/contingency element is satisfied.

Finally, while not a definitive factor, the primary recipients of the subsidy under this foreign-exchange program are undoubtedly manufacturing companies in China that export and that are exporting in ever-increasing amounts so as to benefit from this program. These beneficiaries of China's undervalued-exchange-rate regime accordingly are export-oriented.

In summary, when Articles 1, 2, and 3 of the SCM Agreement are scrutinized in light of their texts and pertinent dispute settlements, China's enforced undervaluation of the yuan is shown to be a prohibited de facto export subsidy. Under Article 3.2 of the SCM Agreement and China's commitments made upon its accession to the WTO, therefore, China is bound to terminate and cease granting all benefits under this export subsidy.

v. The Conclusion That China's Maintenance of An Undervalued-Exchange-Rate Regime Is a Prohibited Export Subsidy Is Reinforced By Items (b) and (j) of the Illustrative List of Prohibited Export Subsidies in Annex I of the SCM Agreement

The unlawful nature of China's maintenance of an undervalued-exchange-rate regime as a prohibited export subsidy is punctuated by several aspects of that scheme that are covered by item (b) and item (j) of the SCM Agreement's Illustrative List at Annex I of prohibited export subsidies. The conclusion that China's exchange-rate misalignment is a prohibited export subsidy and a prohibited import-substitution subsidy is not dependent upon a finding that certain aspects of the programs used to implement the scheme are separately identified on the SCM's Illustrative List of export subsidies. But the inclusion of certain Illustrative List practices within the overall scheme of China's undervaluation of the yuan contributes to a finding that the entire program is a prohibited export subsidy and undermines arguments that the Chinese government's currency regime is WTO-compliant.

(a) Item (b)

Item (b) identifies as prohibited export subsidies "{c}urrency retention schemes or any similar practices which involve a bonus on exports." Currency-retention schemes have been defined as arrangements that usually involve dispensation for certain exporters to retain a portion of their foreign-exchange earnings despite a general rule under which residents must surrender receipts of foreign exchange to local banks, or the central bank, in exchange for local currency.[68]

The Chinese government administers a currency-retention scheme under its currency-exchange regime.[69] As such, China's currency-retention program comes under item (b) of the SCM Agreement's Illustrative List of prohibited export subsidies. By providing certain Chinese exporters with preferential access to foreign exchange that China's laws would otherwise require be converted into yuan, China's currency-retention program provides extra financial encouragement to those favored exporters to export. It also appears that China's currency-retention scheme goes even further and additionally extends bonuses to certain high-performing exporters.[70] In each and both of these respects, therefore, the Chinese government's currency-retention program is a prohibited export subsidy within the meaning of item (b) and the SCM Agreement's articles.

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[68] Deborah E. Siegel, Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements, 96 A.J.I.L. 561, 596 (July 2002).

[69] See, e.g., Exhibit 5, Detailed Rule for Implementation of Regulation on Management Over the Verification of Export Collection of Foreign Exchange, Chinalawinfo Laws and Regulations, PRCLEG 1131 (promulgated June 22, 1998) (effective Aug. 1, 1998); Circular on Relevant Issues Concerning Submitting Tax Certificates for Sales of and Payment in Foreign Exchange Related to Non-Trade and Certain Capital Accounts Transactions, Chinalawinfo Laws and Regulations, PRCLEG 2329 (promulgated May 19, 2000) (effective May 19, 2000); and Regulations on the Sale and Purchase of and Payment in Foreign Exchange, Chinalawinfo Laws and Regulations, PRCLEG 526 (promulgated June 20, 1996) (effective July 1, 1996).

[70] Id.

(b) Item (j)

Item (j) identifies the following programs as export subsidies:

> {t}he provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.

As indicated above, China's undervalued-exchange-rate misalignment relies heavily upon the Chinese government's direction of the state-owned banks' currency actions. While not explicitly identified as an exchange-risk program, this system controlled by the Chinese government clearly functions as one given the insignificant fluctuation allowed in the yuan's value. As alluded to earlier, the financial contribution provided by China to its exporters basically eliminates the need for, and the cost of, private exchange-risk programs for exports to the United States. The indirect financial contribution created and supported by the foreign-exchange program clearly benefits Chinese exporters to the United States. The effective peg's nature is such that Chinese exporters to the United States are largely relieved of costs they would otherwise be obligated to pay under any normal currency exchange regime. Exporters to the United States are relieved of any significant exchange risk by the Chinese government's effective pegging and substantial undervaluation of the yuan vis-à-vis the U.S. dollar. This arrangement stands in stark contrast to the situation of exporters in other countries who either must pay for foreign-currency hedges and guarantees or run the risk of unprotected exchange losses. As explained above, other countries that maintain, or have maintained, pegged currencies have adjusted them when they have become unreasonable, untenable, or have caused severe adverse trade effects and so have imposed at least some level of currency risk on their exporters. This is untrue in China.

In assessing the benefit associated with this export subsidy, the proper focus is not on the label the Chinese government ascribes to its actions, but on the substance and nature of the benefit provided to Chinese exporters and their exports (which may be measured by the cost of this program to the Chinese government under item (j), in an unusual departure from the standard benefit-to-the-recipient approach). Chinese exporters who are not required to incur these costs receive a specific and an unfair prohibited export subsidy within the meaning of item (j) and the SCM Agreement's articles as the result of China's undervalued-exchange-rate regime that advantages China's export trade.

c. China's Maintenance of An Undervalued-Exchange-Rate Regime Also Violates China's WTO Obligations Concerning Agricultural Products

In the course of the negotiations leading to China's becoming a Member of the World Trade Organization on December 11, 2001, China committed that, " . . .by the date of accession, China would not maintain or introduce any export subsidies on agricultural products."[71] With respect to its covered agricultural products,[72] therefore, China's undervalued-exchange-rate regime is directly at odds with this unequivocal commitment by China not to maintain or introduce any export subsidies as of the entry into force of its accession agreement on December 11, 2001. This categorical commitment by China informs and governs China's obligations concerning export subsidies on agricultural products under Articles 3, 9 and 10 of the WTO Agreement on Agriculture. These provisions indicate that a Member State shall not provide subsidies in excess of those specified in that Member State's schedule of commitments.

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[71] Report of the Working Party on the Accession of China, WT/ACC/CHN49 at 44 (para. 234) (Oct. 1, 2001).

[72] See China's Schedule of Concessions and Commitments on Goods (Schedule CLII), Annexed to China's WTO Protocol of Accession, WT/MIN(01)/3 (Nov. 10, 2001, WT/MIN(01)/3/Add.1 (Nov. 10, 2001).

The WTO Agriculture Agreement does not itself define what constitutes a "subsidy." It is well-established, however, that the definition of a "subsidy" in Article 1.1 of the SCM Agreement is applicable as well in the context of the Agriculture Agreement, so that in both settings a "subsidy" exists if there is a governmental "financial contribution" that confers a "benefit" on the recipient beyond what otherwise would have been available to the recipient in the marketplace.[73] It is also well-established that the requirement in Article 1(e) of the Agriculture Agreement that "export subsidies" be "contingent upon export performance" is to be understood identically to that same requirement in the SCM Agreement.[74]

Thus, for the reasons set forth in Section III.A.2.b.iv above, China's undervalued-exchange-rate regime constitutes a prohibited export subsidy on its agricultural products sold to the United States. No less than non-agricultural products exported from China to the United States, Chinese agricultural products sent to the United States benefit from the financial contribution conferred by the Chinese government's undervaluation of the yuan, and that subsidy is contingent in fact upon export performance and so is specific. Taken together, China's effective pegging of the yuan to the U.S. dollar and all of the various underlying activities by the Chinese government that result in the yuan's substantially undervalued misalignment are governmental action that play a critical part in encouraging and enabling Chinese exporters to sell their products abroad at heavily subsidized prices.[75] As such, China's undervaluation of the

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[73] See, e.g., Appellate Body Report, Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products, adopted Oct. 27, 1999, WT/DS103/AB/R, WT/DS113/AB/R, para. 87.

[74] See Appellate Body Report, United States – Tax Treatment of "Foreign Sales Corporations," adopted Mar. 20, 2000, WT/DS108/AB/R, para. 141.

[75] See also Appellate Body Report, Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Second Recourse to Article 21.5 of the DSU by New Zealand and the United States, adopted Jan. 17, 2003, WT/DS103/AB/RW2, WT/DS113/ (...continued)

yuan is an export subsidy that is contrary to China's commitment to end export subsidies upon its accession to the WTO and prohibited by the Agriculture Agreement on exports from China to the United States of agricultural products.

3. China's Maintenance of An Undervalued-Exchange-Rate Regime Violates Article XV:4 of the GATT

a. Background

Article XV:4 of the GATT and its accompanying addendum state,

> Contracting parties shall not, by exchange action, frustrate* the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund.
>
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>
> The word "frustrate" is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the Articles of Agreement of the International Monetary Fund, requires payment to be received for its exports in its own currency or in the currency of one or more members of the International Monetary Fund will not thereby be deemed to contravene Article XI or Article XIII. Another example would be that of a contracting party which specifies on an import license the country from which the goods may be imported, for the purpose not of introducing any additional element of discrimination in its import licensing system but of enforcing permissible exchange controls.

While undervalued-exchange-rate regimes like that of China have not been the subject of GATT/WTO challenges, previous deliberations on Article XV:4 give rise to relevant conclusions.

(...continued)
AB/RW2, paras. 145-146 (Canadian governmental action allowing the profitable export from Canada of milk at prices below the cost of production found to be an export subsidy under Article 9 of the Agriculture Agreement).

First, measures that are monetary in form but that have some effect on trade can be considered under the GATT's rules as far as the trade effect is concerned.[76]

Second, even when a monetary measure such as a temporary import surcharge is regarded by the IMF as being necessary to stop a serious deterioration in a country's balance-of-payments position, that measure can be considered and treated under the GATT as an inappropriate, trade-restrictive measure and an undue burden upon the import account of the country imposing the surcharge with consequent serious effects on the trade of other Member States of the WTO.[77]

Third, as between Article XV:4 and Article XV:9 of the GATT, the question of their relationship has been left for empirical consideration if and when particular points arise that have a bearing on that relationship, and general principles about that relationship have not been laid down by the Member States. Issues in this regard can be pursued by means of dispute settlement under Article XXIII of the GATT, and Article XV:9(a) of the GATT does not preclude the Member States from discussing with a Member State the effects on other Member States' trade caused by exchange controls or restrictions maintained by that Member State.[78]

Fourth, it is often quite difficult or impossible to define clearly whether a governmental measure is financial or trade in nature, and a given measure can be both.[79]

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[76] See 1981 Report of the Committee on Balance-of-Payments Restrictions, Italian Deposit Requirement for Purchases of Foreign Currency, BOP/R/119, adopted Nov. 3, 1981, C/M/152.

[77] See Report of the Working Party, United States Temporary Surcharge, adopted Sept. 16, 1971, BISD 18S/212, 222, para. 39.

[78] Id. at para. 8. Article XV:9(a) of the GATT states that "{n}othing in this Agreement shall preclude: (a) the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that contracting party's special exchange agreement with the CONTRACTING PARTIES. . . ."

[79] See Report of the Special Sub-Group, Relations Between the GATT and the International Monetary Fund, adopted Mar. 2, 4, and 5, 1955, BISD 3S/170, 196, para. 2.

Fifth, and lastly, analysis of a measure that is arguably both financial and trade in character entails a number of steps designed to ensure that the measure is not inconsistent with either the GATT or with the IMF's Articles of Agreement.[80] Thus, in the early 1950s, Greece instituted the levy of a special "contribution" on certain imported goods. Greece described this payment as "a charge imposed on foreign exchange allocated for the importation of goods from abroad equivalent to a multiple currency practice" and designed to cover a widening gap between Greece's official exchange rate and the effective purchasing power of the drachma.

The panel ultimately concluded that more information was needed to render a ruling on the merits, and the matter was resolved without further dispute settlement when Greece thereafter terminated the measure following devaluation of the drachma in April 1953. Prior to that point and in deferring further consideration, however, the panel outlined its train of thought as to how the matter subsequently should be evaluated. In particular, the panel remarked that (1) the principal question was whether the Greek tax was an internal tax or a charge on imported products under Article III:2 of the GATT, in which event the panel would decide if the tax was consistent with that provision; (2) on the other hand, if the charge were, as Greece contended, a tax on foreign exchange allocated for the payment of imports, the question for the IMF would be whether the measure constituted a multiple currency practice and was in conformity with the IMF's Articles of Agreement, in which case the Greek charge would fall outside the scope of Article III of the GATT; and (3) even if the Greek measure was outside the ambit of Article III of the GATT, " . . . the further question might arise under Article XV:4 whether the action of the

[80] See Panel Report, Special Import Taxes Instituted by Greece, adopted Nov. 3, 1952, BISD 1S/48 ("Greek Taxes").

Greek Government constituted frustration by exchange action of the intent of the provisions of Article III of the General Agreement."[81]

In short, under the panel's sound thinking in Greek Taxes, even if no other provision of the GATT is deemed to have been violated by a measure, and even if no provision of the IMF's Articles of Agreement has been violated by that measure, that measure can still run afoul of Article XV:4 of the GATT if that measure is exchange action that "frustrates" the intent of the GATT's provisions.

b. By Maintaining An Undervalued-Exchange-Rate Regime, China Is Wrongly Frustrating the Intent of a Series of the GATT's Provisions

To "frustrate" something is to prevent or thwart the attainment of a purpose or to nullify, defeat, or bring a goal to nothing. Within the legal framework described immediately above, China's undervaluation of its yuan is "exchange action" under Article XV:4 that insidiously has been acting to frustrate the linchpins of the international trading system.[82]

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[81] See id. at paras. 5, 7, and 8.

[82] China's undervaluation of the yuan can also be seen as "trade action" under Article XV:4 that frustrates the intent of the IMF's Articles of Agreement. Under Article IV, Section 1(iii) of those Articles, for example, each member of the IMF shall ". . . avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." This general obligation is based upon the recognition that ". . . the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability . . . ." Even if the yuan's undervaluation is not viewed in this light, however, this measure by China is one that is monetary in form and trade-restrictive in effect and consequently violative of Article XV:4 as "exchange action" that frustrates the intent of various provisions of the GATT. See 1981 Report of the Committee on Balance-of-Payments Restrictions, Italian Deposit Requirement for Purchases of Foreign Currency, BOP/R/119, adopted Nov. 3, 1981, C/M/152; and Report of the Working Party, United States Temporary Surcharge, adopted Sept. 16, 1971, BISD 18S/212, 222, para. 39.

While the purpose of the GATT as a whole can be articulated in a variety of ways, perhaps the most powerful expression of its far-reaching aims is found in the Preamble to the Agreement Establishing the World Trade Organization. In pertinent part, that Preamble speaks of ". . . raising standards of living, ensuring full employment and a large and steadily growing volume of real and effective demand, and expanding the production of and trade in goods . . . ." The Preamble goes on to indicate that the Parties to the WTO's Agreement are to contribute to these objectives ". . . by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations . . . ."

China's maintenance of an undervalued-exchange-rate regime is "exchange action" that violates Article XV:4 by frustrating the intent of the GATT's fundamental Articles that are meant to serve as the means to achieve the ends incorporated in the Preamble of the WTO's Agreement. This frustration of the intent underlying the GATT's provisions is apparent from different vantages, any one of which suffices to establish a violation of Article XV:4.

Under Article I of the GATT and the principle of most-favored-nation ("MFN") status, imports by China from the United States are to be treated no less favorably than imports into China from any other Member State of the WTO. This principle of non-discrimination, however, is undercut by China's undervalued-exchange-rate regime. Whenever the U.S. dollar appreciates against the currency of a third country, the yuan automatically and comparably appreciates against that third currency, but not against the U.S. dollar, due to the effective pegging of the yuan to the U.S. dollar. As a result, the third country's products become more attractively priced and competitive for export to China while U.S. products do not. Imports into

China from the United States consequently are disadvantaged vis-à-vis imports from other countries and denied MFN treatment.

Under Article II of the GATT, China's tariff bindings are not to be exceeded. China's ad valorem customs duties, however, when applied to the inflated, yuan-denominated prices that result from China's undervaluation of the yuan, yield similarly inflated amounts of yuan-denominated customs duties. In a perverse fashion, the weakening of the U.S. dollar means a commensurate weakening of the yuan and a corresponding increase in the amount of yuan-denominated customs duties that the Chinese importer must pay. China's tariff bindings become unacceptably elastic and uncertain and effectively exceeded as a result.

Under Article III of the GATT, China is obligated not to apply to domestic or imported products any laws, regulations, and requirements that affect the internal sale, offering for sale, purchase, transportation, distribution or use of products so as to afford protection to domestic production. China's effective pegging of the yuan to the U.S. dollar and currency controls, however, negate or erode this non-discriminatory principle of national treatment by so inflating the yuan-denominated price of imports into China from the United States that U.S. products are either excessively or prohibitively expensive and Chinese-origin products are favored and protected.

Under Articles VI and XVI of the GATT, China has committed to abide by the principle that export subsidies are prohibited. The Chinese government's persistent undervaluation of the yuan as compared to the U.S. dollar, however, acts in fact to subsidize all products exported from China to the United States.

Under Article XI of the GATT, China is barred generally from imposing measures other than duties, taxes or other charges that prohibit or restrict imports into China of any product from

the United States. China's undervaluation of the yuan, however, variously serves to prohibit and restrict imports into China of products from the United States by so increasing the yuan-denominated prices of U.S. products that Chinese importers either cannot afford to import the U.S. products at all or can only import lesser quantities of the U.S. products than would be the case were the yuan commercially valued realistically against the U.S. dollar.[83]

By way of recapitulating, therefore, by means of the expedient of undervaluing and misaligning its currency as it has, China dramatically has frustrated the intent of the GATT. This exchange action by China at once is undercutting all of the GATT's principal concepts that together have formed the backbone of the international trading system since the end of World War II. With reference to the addendum to Article XV:4, China's undervaluation of the yuan appreciably departs from the intent of the foregoing provisions of the GATT. In actuality, China's refusal to set a realistic exchange rate for the yuan based on market conditions or allow the yuan to seek its own market-driven balance against the U.S. dollar is a direct challenge to the GATT's principles with debilitating effects both for the United States and the global economy as a whole. China's undervaluation of the yuan violates Article XV:4 of the GATT.

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[83] In connection with an early draft of Article XV, the link between Article XI's general prohibition against quantitative restrictions and Article XV's purpose of preventing exchange arrangements or exchange action from frustrating the intent of the GATT's provisions was underscored. As explained by the U.S. delegate at a drafting session in 1946, Article XV's focus is that ". . .exchange restrictions will not be imposed on imports from other members. That corresponds to the basic provision that quantitative restrictions will not be used, the one being regarded as an alternative to the other." U.N. DOC. EPCT/C.II/PV.8, at 5 (1946). See also Art. XV:5, which states that the Member States shall report to the IMF if, at any time, they consider that exchange restrictions on payments and transfers as to imports are being applied by any Member State in a manner inconsistent with the GATT's exceptions for quantitative restrictions.

B. China's Maintenance of An Undervalued-Exchange-Rate Regime Is Unjustifiable and Burdens and Restricts U.S. Commerce By Violating China's Obligations Under the International Monetary Fund's Articles of Agreement

Section 301(a)(1) of the Trade Act of 1974 requires the USTR to take mandatory action if "an act, policy, or practice of a foreign country -- . . . (ii) is unjustifiable and burdens or restricts United States commerce." Furthermore, under section 301(d)(4)(A), "An act, policy, or practice is unjustifiable if the act, policy, or practice is in violation of, or inconsistent with, the international legal rights of the United States."

China's policy of maintaining an undervalued-exchange-rate regime is a violation of its obligations under the IMF's Articles of Agreement. In 1980, China assumed Taiwan's seat in the IMF and received one seat on the Board of Executive Directors. In 1996, two years after China had unified and realigned its exchange rate, China removed exchange restrictions on its current-account transactions by accepting Article VIII of the IMF's Articles of Agreement. Between 1996 and July 2005, China maintained its exchange rate at 8.28 yuan per dollar and since then has effectively continued to peg the yuan to the U.S. dollar at a substantially undervalued rate. China's policy of maintaining an undervalued-exchange-rate regime violates its obligations under Articles IV and VIII of the IMF's Articles of Agreement.

Article IV requires that each IMF member shall: "(iii) avoid manipulating exchange rates or the international monetary system in order to . . . gain an unfair competitive advantage over other members." First, China's fixed exchange-rate system requires that it intervene in every export transaction in order to maintain the fixed exchange rate, constituting manipulation. In addition, China has instituted capital controls further to enforce the fixed-exchange mechanism. Evidence of the magnitude of the practice is the accumulation of foreign-exchange reserves, which have grown to more than one trillion dollars in 2006, up from $610 billion as recently as

2004. Second, China's policy of maintaining an undervalued exchange rate has given China and particularly China's exports an unfair competitive advantage in trade with the United States and other members of the IMF. China's undervalued-exchange-rate policy subsidizes China's exports to the United States and other countries and denies the United States and other countries the equal treatment required by Articles I and III of the GATT. China's undervalued-exchange-rate system causes prices of U.S. products in the Chinese market to be higher than what would prevail under market conditions and causes prices of China's products to be lower in the U.S. market than what would prevail under market-determined exchange rates. This subsidized practice gives China's products a competitive advantage when competing with U.S. products in the Chinese marketplace, in the United States and in third-country markets, contrary to the obligations under the IMF's Article IV, section 1(iii).

China's policy of maintaining an undervalued-exchange-rate system also violates the IMF's Article IV, section 1(ii), which states that each member of the IMF shall "(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."

China's policy of maintaining an undervalued exchange-rate system is creating financial instability that will eventually disrupt global financial markets unless China appreciates its currency in line with underlying economic fundamentals. The threat to the international financial system is exacerbated by the size of China's economy, China's volume of global trade, and foreign direct investment in China. China's accelerating accumulation of foreign-exchange reserves is generating disequilibrium in the international financial system, will tend to create inflation and over-investment in China, and will lead to the conditions for another international financial crisis.

As described in detail in Exhibit 1, under its fixed-exchange-rate system with tight capital controls, China has sacrificed its fuller integration into the world economy in favor of exchange-rate stability and monetary independence. The inappropriateness of this exchange-rate regime is perhaps best illustrated by the enormous lengths to which the Chinese government must extend its interference in the market in order to achieve these monetary policy goals. Moreover, China's adherence to these goals -- no matter what their cost or how superficially they are achieved -- is even more revealing.

The type of closely controlled exchange regime employed by China ordinarily is confined to countries with relatively minor and/or balanced trade and investment flows with the rest of the world. This situation is due to the fact that large and imbalanced flows can quickly overwhelm such a closely-controlled system, although this danger has yet to prove a deterrent to China. In its dogged pursuit of exchange-rate undervaluation and stability, the Chinese government has had to intervene to purchase ever-greater volumes of foreign exchange (especially U.S. dollars) each year. Nevertheless, while these purchases have succeeded in keeping the yuan's value stable against the U.S. dollar, they completely run counter to the trend in the rest of the world, where the U.S. dollar generally has fallen significantly in value. Thus, when the U.S. dollar fluctuates against other foreign currencies, China's achievement of exchange-rate stability with the U.S. dollar directly undermines achievement of exchange-rate stability with respect to all other currencies which float against the U.S. dollar. In other words, the actual exchange-rate stability achieved by China's enforced undervaluation of the yuan is limited to the U.S. dollar. By virtue of achieving stability with the U.S. dollar, China faces potentially less stability with respect to other currencies.

The other policy goal of monetary independence likewise is undermined by China's maintaining an essentially fixed exchange rate in the face of such large imbalances in its trade and investment flows. As discussed generally in Section II and Exhibit 1, rather than permit the yuan to increase in value, the Chinese government has chosen instead to offer any amount of yuan needed to absorb any supply of foreign currency. Consequently, as shown in the table below, as larger and larger foreign-currency surpluses have flowed into the Chinese market, the Chinese government has had to flood the market with more and more yuan. Thus, if China wishes to maintain exchange-rate stability in the face of such foreign-currency inflows, it does so at the cost of its control over its domestic money supply. Along with this rapid growth in the money supply, however, there is increasing evidence that the Chinese government has fostered a speculative over-investment boom and the foundation for much higher inflation in the future. If not corrected, these trends will coalesce in an unstable bubble that, due to the size of China's economy and volume of trade, will adversely affect international trade and financial markets, contrary to the obligations in the IMF's Article IV, section 1(ii).

Money Supply
(Billion Yuan)

	2000	2001	2002	2003	2004	2005	2006
Money	5,454	6,168	7,088	8,412	9,582	10,690	12,604
% increase	--	13.1%	14.9%	18.7%	13.9%	11.6%	17.9%
Quasi Money	8,142	9,472	11,412	13,710	15,724	19,148	22,006
% increase	--	16.3%	20.5%	20.1%	14.7%	21.8%	14.9%

Source: IMF: International Financial Statistics

China's policy of maintaining an undervalued-exchange-rate regime also violates the IMF's Article VIII, section 3, which states:

> No member shall engage in, or permit any of its fiscal agencies referred to in Article V, Section 1 to engage in any discriminatory currency arrangements or multiple currency practices, whether within or outside margins under Article IV or prescribed by or under Schedule C, except as authorized under this Agreement or approved by the Fund.

As previously discussed, China's undervalued-exchange-rate policy discriminates against U.S. exports of goods and services. By maintaining an undervalued exchange rate for the yuan against the U.S. dollar, China discriminates against U.S. products to China's benefit. Prices of Chinese goods and services in the U.S. market are lower than what would prevail under an exchange rate that reflected underlying economic fundamentals. Conversely, the prices for U.S. products in China are higher than what would prevail with an exchange rate that reflected underlying economic fundamentals.

In addition, China's undervalued exchange rate discriminates against other IMF countries. As the U.S. dollar depreciates against other currencies, the exchange rate with China does not change, and the advantage that China has through its undervalued exchange rate remains the same. Other currencies adjust simultaneously to the yuan and the U.S. dollar, because the exchange rate is essentially pegged. Those currency adjustments, however, must be greater than what would be required under market conditions, because the yuan is undervalued and unable to appreciate significantly in real terms against the dollar. China's undervalued exchange rate clearly discriminates against the United States and other IMF members. The fact that China has shown no real flexibility indicates that China has continued to be in violation of its obligations to the IMF under Article VIII of the IMF's Articles of Agreement.

C. Summary

China's undervaluation of the yuan vis-à-vis the U.S. dollar violates basic and essential principles and provisions of the World Trade Organization and its agreements as well as vital

obligations of China under the IMF's Articles of Agreement. China's undervalued-exchange-rate misalignment of its currency and the magnitude of the adverse consequences flowing from China's behavior for the United States and the global economy are unprecedented and should not be tolerated.

By the expedient of the yuan's severe undervaluation, the Chinese government is doing great harm to the WTO's rules-based system and also to the international monetary system. On the one hand, as this section emphasizes, the yuan's undervaluation comprehensively subsidizes all of China's exports. On the other hand, the yuan's undervaluation – as a practical matter – variously acts as a tax, added import duty, and effectively as a quantitative restriction on imports into China. These far-reaching effects of the yuan's undervaluation at a minimum frustrate the GATT's basic intention of opening markets. Indeed, China's utter refusal to eliminate this undervaluation immediately and the large-scale and harmful consequences of this intransigence for the global economy present issues of first impression that Articles I, II, III, and XI of the GATT are being violated. These problems are addressed in the Attachment to this petition.

If China's accession to the WTO in December 2001 is to be a constructive step, it is imperative that China – as the major trading country that it is – honor its obligations. Under 19 U.S.C. § 2411(a), therefore, the Bipartisan China Currency Action Coalition urges that mandatory action be taken to enforce the international legal rights owed by China to the United States.

IV. CHINA'S POLICY OF AN UNDERVALUED YUAN IS HAVING A DEVASTATING EFFECT ON U.S. PRODUCTION

A. Overview

China's exchange-rate policy effectively pegs its currency solely to the U.S. dollar regardless of the underlying economic fundamentals or relative competitive conditions between

the two countries. As explained in detail in Exhibit 1, the other countries joining China in employing such an exchange-rate regime are predominantly very minor economies in the Caribbean, Middle East and Africa, none of which is a major exporter to the United States or to the rest of the world. By virtue of their small size, these economies simply are not capable of materially distorting global trading patterns, regardless of the exchange-rate fluctuations that might occur absent such regimes.

The same cannot be said of China, as recognized directly by the Administration, which repeatedly has called on China to no avail to allow at least some real fluctuation in its exchange rate or, better yet, to move to a floating regime along with the other major trading nations whose ranks China now has joined.

Instead, China has held steadfastly to its essentially fixed-rate regime in the face of soaring trade surpluses and foreign-direct-investment inflows. Moreover, it is no accident that the United States – the country to whose currency China has pegged the yuan – has been a primary source of China's trade surpluses and foreign-direct-investment inflows. As discussed above, the end result of the trade between the United States and China is a massive oversupply of U.S. dollars and undersupply of yuan that normally would cause the yuan to rise in value vis-à-vis the U.S. dollar. In order to prevent an appreciation of its currency, the Chinese government must squelch market forces on each side of the trading relationship by absorbing the excess U.S. dollars (which, to date, have been heavily recycled into U.S. governmental debt for lack of other uses given the magnitude of the surfeit), while simultaneously flooding the Chinese market with, and then sterilizing, huge quantities of undervalued yuan.

China's strategy raises at least one obvious question. Why is the Chinese government willing to risk inflation and overheating its economy (by expanding its money supply in order to

absorb the excess foreign currency), as well as increasingly to orchestrate banking activity in the country, while investing in a currency that is otherwise losing value, rather than simply let the value of the yuan mediate these forces and imbalances? While the answer to this question is complex and multi-dimensional, the yuan's role is clearly of central importance to the Chinese government's actions. If permitting the exchange rate to fluctuate would resolve many of these issues for China, then its steadfast refusal to permit any meaningful change in the exchange rate must confer some benefit. Given the trade imbalances that have resulted due to the yuan's undervaluation, it is likewise clear that one of the principal benefits to China is a compelling competitive advantage in trade with the United States.

China's artificially-maintained competitive advantage in trade with the United States translates into a de facto competitive disadvantage for the United States and its businesses competing with China, whether in the United States, in China, or in third-country markets. This competitive disadvantage has grown steadily more oppressive for U.S. businesses in recent years as relative economic conditions have changed not only in the United States and China, but also in the rest of the world. The widespread and significant decline in the value of the U.S. dollar against the major foreign currencies other than the yuan since the end of 2001 is perhaps the best single indicator of these changes. Since that time, the U.S. dollar has declined by 17 percent (as of December 2006) against the currencies of its major trading partners (excluding China).[84] Although China is now a major trading partner of the United States, its currency has remained virtually unchanged in value versus the U.S. dollar over that same period of time. Thus, under current economic conditions, the longstanding undervaluation of the yuan has become

[84] Federal Reserve Statistical Release H.10, Foreign Exchange Rates – Broad Index. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners.

indisputable and injurious, as manifested so clearly in the United States' trade deficit with China, which has not only reached historic proportions, but continues to grow rapidly.

The Chinese government's ever-expanding exertions to foster and maintain its significantly undervalued exchange rate effectively preclude any competitive advantage that would otherwise be gained by U.S. commercial interests from such a sustained and substantial decline in the value of the U.S. dollar elsewhere in the world. The result for U.S. commerce vis-à-vis any individual Chinese good in any market in the world is the inability to gain competitive cost or price traction against Chinese products. In effect, the undervalued yuan prevents U.S. producers from regaining levels of output and sales appropriate to current global economic conditions, as well as the unit-cost declines that typically accompany expanded output.

Moreover, U.S. producers consequently do not benefit from the restoration of profits that greater cost-competitiveness should bring. Those U.S. producers whose market is primarily or exclusively domestic have seen imports into the United States from China escalate extraordinarily while the yuan has been so undervalued. Nor can U.S. companies rely on growth in export markets, in particular to fast-growing China, as any exchange-rate declines in U.S. export prices are instantaneously matched by corresponding declines in Chinese export prices. With U.S. businesses facing greater Chinese competition at home and abroad across a widening spectrum of goods, U.S. commerce increasingly will be burdened and restricted by the Chinese government's currency policy if left unaddressed by the U.S. government.

The dangers to the international trading and financial system cannot be underestimated. History provides a recent, valuable lesson on the dangers of China's currency practices and calls

for immediate action. According to economists,[85] China's devaluation of the yuan in the early 1990s had a significantly adverse economic effect on the economies of Southeast Asia and, by extension, the rest of the world. The Asian Financial Crisis, according to Surjit S. Bhalla,[86]

> . . . occurred because of over-investment and over production; such over production was caused by planning for a future which had not correctly anticipated the important role that Chinese production, and low Chinese cost, would play; comparative costs became important because of the 50 percent Chinese devaluation (in the guise of exchange rate reform) that was allowed to occur between 1990 and 1993; capital continued to flow to East Asia because of the promise of high returns (bad anticipation of China's role) and because of the promise of stable returns (quasi-fixed exchange rate). Once the trade shares of the East Asian economies were affected, investments became relatively unprofitable; and once Thailand showed the way, the other East Asian competitors of China followed.

China's maintenance of an undervalued-exchange-rate regime is creating the same imbalances in trade and over-investment that occurred in the early- to mid-1990s, which culminated in the Asian Financial Crisis. China's unwillingness to address these imbalances meaningfully threatens the international trading and financial system with a similar crisis. Unlike the last Asian Financial Crisis, a new, China-led crisis is likely to have a far greater impact on the United States given the extent of the greatly-expanded trading and investment relationships between the two countries, the effective pegging of the undervalued yuan to the U.S. dollar, and the already strained economic and fiscal conditions now prevailing in the United States. It is even less certain to what extent many U.S. businesses could withstand such an exogenous shock on top of the burdens they already face.

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[85] C. Fred Bergsten, "The Asian Monetary Crisis: Proposed Remedies," prepared remarks to the U.S. House of Representatives, Committee on Banking and Financial Services, November 13, 1997; John H. Makin, "The New Paradigms," American Enterprise Institute (October 1997).

[86] Surjit S. Bhalla, Chinese Mercantilism: Currency Wars and How the East Was Lost, Indian Council for Research on International Economic Relations (July 1998).

B. Both U.S. Imports From China and the U.S. Trade Deficit With China Are Soaring

Since 2001, U.S. consumption of manufactured goods grew by only three percent, while U.S. imports of manufactured goods from the entire world except for China rose proportionally, increasing by a moderate 4 percent. In marked contrast, U.S. imports of manufactured goods from China skyrocketed by 49 percent in the same time period – a remarkable performance considering that China was already the fourth leading foreign supplier to the United States of manufactured goods at the start of the period, behind only Canada, Japan and Mexico. As of 2006, China is now second among the leading suppliers of imported manufactured goods to the United States.

In fact, the growth in U.S. imports from China was so rapid in relation to the rest of the world that it accounted for 56 percent of the total growth in U.S. imports of manufactured goods between 2001 and 2003 and has only risen further since then. In other words, the increased volumes from China alone have exceeded the increase in volumes from every other country in the world combined. The impact of the increased U.S. imports from China on U.S. businesses has been the subject of much debate in the course of discussing recent trends in trade between the two countries. As this debate has unfolded it has tended to become more polarized, with some observers asserting that China's gains have come predominantly at the expense of U.S. manufacturers, while others assert that China's gains have come predominantly at the expense of other foreign suppliers. As the analysis in this section demonstrates, however, U.S. manufacturers have borne the brunt of China's gains in the U.S. market, not only because it is the most important market for U.S. manufacturers (who therefore have the most to lose here), but also because, unlike foreign producers, U.S. manufacturers are denied any competitive exchange-rate adjustments vis-à-vis China in the U.S. market.

As noted above, the overall U.S. trade deficit with China is the largest bilateral imbalance ever seen in the history of world trade. More specifically, the annual, overall U.S. merchandise trade deficit with China was $235 billion in 2006, $203 billion in 2005, $163 billion in 2004, and $125 billion in 2003, and appears on pace in 2007 to exceed 2006's deficit. In short, despite strong growth in U.S. exports of manufactured products and all merchandise to China, the much larger volumes and similar growth rate in corresponding U.S. imports from China have caused the trade deficit to soar. By the end of 2006, both import volumes from China and the trade deficit with China were so large that even a significant slowing in the future growth in imports from China will be insufficient to cause a material change in the U.S. trade deficit with China, as explained further below.

C. If Recent Trends Continue, the U.S. Trade Deficit With China Will More Than Double in Five Years

Since China pegged its currency to the U.S. dollar in 1994, U.S. imports from China have increased at an average annual rate of 18 percent through 2006, while corresponding U.S. exports to China have increased at an annual average rate of 16 percent. Like all compounded values, even small differences in growth rates over time will produce large differences in final values, particularly if, as in the case of trade between the United States and China, there are large differences in the starting values. Consequently, a seemingly modest difference in relative growth rates has nonetheless produced a yawning gap between total U.S. imports from China, which reached $287 billion in 2006, and total U.S. exports to China, which reached only $52

billion in 2006. If historical growth rates continue for just five more years, the annual U.S. trade deficit with China will expand to $548 billion by the end of 2011.[87]

Possible Trends in the U.S.-China Trade Deficit in the Next 5 Years ($ billions)
Have We Reached the Point of No Return?

		U.S. Imports from China			
Alternative Growth Scenarios for U.S. Imports/Exports with China		**8%** *(Slower growth)*	**18%** *(Historical average growth)*	**24%** *(Faster growth)*	**18%** *(2006 actual growth)*
U.S. Exports to China	**33%** *(2006 actual growth)*	**($207)**	**($442)**	**($627)**	**($442)**
	16% *(Historical average growth)*	**($313)**	**($548)**	**($733)**	**($548)**
	12% *(Slower growth)*	**($331)**	**($566)**	**($751)**	**($566)**
	3% *(Slowest growth)*	**($362)**	**($597)**	**($782)**	**($597)**

As the volumes of both U.S. imports from China and U.S. exports to China increase, and as the trading relationship between the countries matures further, it is possible that future growth rates will diverge from their respective 12-year historical averages, as has been the case in some past years. Due to the differences in the sheer volume of the trade flows, however, even if U.S. exports continue growing at the accelerated pace of 33 percent evident in 2006, while U.S. imports merely maintain their historical growth rate of 18 percent, the U.S. trade deficit of $235

[87] By 2011, at the historical averages, U.S. imports from China will increase to $657 billion, while U.S. exports to China will increase to $108 billion. As a result, the U.S. trade deficit to China in 2011 will increase to $548 billion, or by 133 percent of the 2006 deficit of $235 billion.

billion in 2006 will continue to expand. As shown in the table above, this relatively optimistic scenario results in an increase of nearly $207 billion in the U.S. annual trade deficit to $442 billion in 2011.

As clearly depicted in the table, any expectations that continued strong U.S. export growth will halt or even reverse the growing trade deficit with China likely will prove to be badly mistaken absent a significant slowing in import growth due to the sheer magnitude in the volume of imports from China.

The central question is how to slow imports from China without resorting to measures that would violate global trade rules and without potentially endangering the comparatively small but still important inroads the United States has made in the Chinese market. While U.S. businesses expect China's market to become even more important, current trends are leading to a tipping point where the much-awaited potential of the Chinese market will be dwarfed, perhaps permanently, by the heavy losses already sustained by U.S. companies and workers in the U.S. domestic market. The longer the Chinese government is permitted to continue to undervalue and misalign its trade relationship with the United States, these data make clear that the costs and risks for the United States will increase commensurately.

D. U.S. Production Is Being Displaced By Imports Into the United States From China

While the above figures are indisputable, some observers discount the effect U.S. imports from China are having on the U.S. domestic manufacturing base despite their sustained and meteoric rise. This alternative view centers on allegations that increased imports from China merely displace imports from other low-wage countries rather than U.S. domestic production, essentially leaving U.S. domestic output and employment unaffected. Fundamentally, increased U.S. imports from China can only come at the expense of three potential sources, as follows:

(1) directly from U.S. production, if the overall market is flat or declining;

(2) directly from other foreign production, if the overall market is flat or declining; and,

(3) indirectly from U.S. and/or foreign production, if the overall market is growing.

At the outset, the salient point is that, regardless of whether China's gains come at the expense of existing domestic or foreign production, or due to an expansion in the overall market, all such gains represent some mix of actual and potential losses to U.S. domestic production. While the direct losses to U.S. domestic production illustrate this most emphatically, the fact is that increased imports from China could also displace domestic production that otherwise would have gained share from other foreign production (particularly from countries whose currencies have appreciated significantly vis-à-vis the U.S. dollar), or from an expansion in the market.

Nevertheless, despite compelling and wide-ranging evidence to the contrary, some observers highlight the fact that China's share of total U.S. imports has increased, while other countries' shares of total U.S. imports have fallen. These observers take these trends as evidence that China's gains in the U.S. market have come significantly, or even largely, at the expense of other foreign production rather than from U.S. domestic production.[88] Mere comparisons of relative import market shares, however, are not meaningful, because all countries' shares must,

[88] Coincident with the very rapid and massive increase in U.S. imports from China that is entirely concentrated in manufacturing goods, U.S. manufacturing employment suffered unprecedented erosion. From August 2000 through February 2004, manufacturing employment declined for 43 consecutive months before the streak finally was broken in March 2004, according to the U.S. Bureau of Labor Statistics. Over the course of the uninterrupted decline, more than three million U.S. manufacturing jobs were lost (most by production workers), leaving U.S. manufacturing employment at its lowest levels since 1950. While there were multiple causes for this decline in employment, it is difficult to see how an unprecedented rise in manufactured imports and an unprecedented decline in domestic manufacturing employment can be argued to be only loosely related or even unrelated. Manufacturing employment in the United States has continued to suffer to the present.

by definition, total 100 percent. As U.S. imports from China rise more rapidly than U.S. imports from other countries, mathematically China's share of total imports must rise, while other countries' collective share must fall because the total import market, regardless of its absolute size, will always equal 100 percent.

Additionally, some observers conclude that exports to the United States from China must have displaced exports from other Asian countries, rather than U.S. production, based on evidence that U.S. imports from China have risen while overall imports from Asia have remained largely stagnant. As an initial matter, the difficulty with this view is that there is no à priori reason why imports should be increasing more quickly than U.S. production, particularly during a period when U.S. economic growth slowed and the U.S. dollar declined significantly in value. Why did U.S. imports from China grow so much more quickly than those from other countries, including countries whose wages are as low as, or even lower than, China's? Unfair trading conditions driven by China's undervalued currency must be a primary factor, particularly given that China's export prices in yuan have fallen by nearly 30 percent since 1995, aided by an exchange-rate regime that was not permitted to function and balance the shift in relative prices between the U.S. and Chinese markets.

The table below summarizes China's actual trade performance in the United States compared with China's primary lower-wage Asian competitors (i.e., India, Malaysia, Thailand, Singapore, Korea and Taiwan) in the 2001-2006 period. As an initial matter, the data show that, on an annual basis, total U.S. imports from these other Asian countries collectively increased by 40 percent or by more than $51 billion, while those from China surged by 181 percent or by nearly $185 billion in the period. Thus, there is no factual basis for claims or arguments that U.S. imports from other Asian countries competing with China have declined or remained

stagnant. As shown, U.S. imports from these countries have not only increased, but also have done so despite generally appreciating currencies in the region versus the U.S. dollar over the period.

Moreover, when the increase in U.S. imports from China is viewed in the context of the typical U.S. import volume from these other countries, it becomes even clearer that any purported reduction in U.S. imports from these countries at the hand of Chinese suppliers during this period was modest at best. As shown, total U.S. imports from these other countries were $130 billion in annual 2001 and $181 billion in annual 2006, an increase of 40 percent. In other words, the existing import volume into the United States from these other countries simply is not small enough to support the thesis that products sourced by China from these other Asian countries are a significant part of China's increased volume of exports to the United States.

The only way a displacement argument can be defended in light of these data is if it is further assumed that imports from these other countries would have increased substantially more than they actually did. Such an assumption runs counter to prevailing economic conditions during the period, which included a sharp contraction in technology-related production and a sustained depreciation in the U.S. dollar, despite which imports from these countries still managed to increase significantly. Without the benefit of such a strained assumption, therefore, the data more strongly support the line of reasoning that U.S. domestic production has suffered much greater displacement from the increase in imports from China than is the case for China's other Asian competitors.

Comparison of China's and Other Asian Countries' U.S. Trade Performance

	Exchange Rates (foreign currency per U.S. dollar)			U.S. Imports (millions of U.S. dollars)		
Country	Dec 2001	Dec 2006	Chg vs USD	Annual 2001	Annual 2006	Pct Chg
China	8.2768	7.8087	5.66%	$ 102,069	$ 287,052	181%
India	48.180	44.245	8.17%	$ 9,708	$ 21,674	123%
Malaysia	3.80	3.5315	7.07%	$ 22,228	$ 36,441	64%
Taiwan	33.824	32.506	3.90%	$ 33,262	$ 38,086	15%
Singapore	1.85	1.53	17.3%	$ 14,899	$ 17,750	19%
Korea	1,313.50	929.80	29.21%	$ 34,917	$ 44,714	28%
Thailand	44.222	36.045	18.49%	$ 14,672	$ 22,345	52%
Subtotal	NA	NA	NA	$ 129,686	$ 181,010	40%

While examining relative import market shares or comparing absolute levels of U.S. imports from among different countries provides a rough estimation of the extent to which increased imports from China have displaced U.S. production or imports from other countries, the true displacement effect of imports from China can be determined more precisely by examining import volumes in relation to corresponding domestic production and apparent consumption and identifying changes in import penetration as a proxy for the displacement effect. Sectoral data on U.S. shipments, imports and exports of manufactured goods published by the U.S. Census Bureau permit a comprehensive analysis of import penetration using the maximum level of industry detail available. The analysis examines U.S. imports of manufactured goods from China and from the rest of the world and relates them to domestic U.S.

manufactured goods production and apparent consumption[89] on a sector-by-sector basis from annual 2000 to annual 2003.

This analysis provides further confirmation that while a significant amount of China's rising sales to the U.S. market appears to have displaced other imports, a much greater portion of the increase appears to have displaced domestic U.S. producer share of the U.S. market. In order to distinguish between China's displacement of domestic U.S. producer share and China's displacement of imports from other countries, the analysis focuses first on the overall import penetration in the U.S. market. For each of the 58 discrete durable and non-durable goods sectors analyzed, if China's import penetration increased while overall import penetration remained flat over the period, then the increased imports from China were assumed to displace only imports from other countries, leaving no net displacement of domestic U.S. producer share. Conversely, if overall import penetration increased as much as or by more than China's import penetration, then the increased imports from China were assumed to displace only domestic U.S. producer share, leaving no net displacement of imports from other countries.

The analysis concludes that 60 percent of the total increase in U.S. imports from China over the period led to increases in China's share of the U.S. market that came at the expense of the market shares of domestic producers. The remaining 40 percent of the increase in U.S. imports from China, while likewise increasing China's share of the U.S. market, was not accompanied by an overall increase in import penetration and, therefore, was assumed to have

[89] Apparent consumption is derived by adding domestic production and U.S. imports, then deducting U.S. exports, because exports are included in domestic production but not consumed in the United States.

come at the expense of the market shares of other foreign producers rather than the market shares of U.S. domestic producers.[90]

In summary, the analysis leads to the conclusion that the 60-percent share of total U.S. imports from China that was found to displace U.S. domestic producers' market share in the United States translated into a $31 billion gain for China's producers. To put the value of this displacement in perspective, it should be considered that total U.S. manufacturers' shipments fell by $209 billion between 2000 and 2003. China's displacement of U.S. domestic producers' share thus is equivalent to almost 15 percent of the overall decline in U.S. manufacturers' shipments over this period.

E. Cost Pressure on U.S. Manufacturers Is Rising Due to Imports Into the United States From China

China's extremely low prices, aided in significant part by the undervalued yuan, are putting tremendous pressure on U.S. domestic firms by undercutting their pricing power. As U.S. production and especially non-production costs (such as medical-care costs, litigation costs, etc.) rise, U.S. companies find they are unable to pass these costs on to their customers, in large

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[90] U.S. government data disaggregate current manufacturing production into 58 categories or sectors. The analysis examines each category to determine that China's overall market share of U.S. manufactured goods consumption increased by 1.1 percentage points over the period analyzed. Given that the total U.S. market for manufactured goods was $4.5 trillion in 2003 (based on U.S. manufacturers' shipment data, rather than value-added), the increase in China's overall market share translates into a $50 billion increase in China's sales to the U.S. market.

This 1.1-percent increase in market share pertains to all sales of Chinese goods in the U.S. market, whether they displaced domestic production or imports from other countries. The portion of this market-share increase that appears to have displaced domestic production (i.e., not offset by declines in market share from other countries) equals 0.7 percent of U.S. consumption of manufactured goods, or about $31 billion. The balance of China's overall market-share gains, or 0.4 percent of U.S. consumption of manufactured goods, appears to have displaced other foreign production rather than U.S. production (i.e., was offset by declines in market share from other countries). Thus, between 2000 and 2003, approximately 60 percent of China's increased import penetration appears to have displaced U.S. production, while the balance appears to have displaced imports from other countries.

part because of intense price suppression in the U.S. market by China's exporters. Consequently, many U.S. firms are unable even to cover their costs, let alone make a sufficient profit to sustain investments needed to improve competitiveness and remain in business. As a result, increasing numbers of companies are considering temporary or permanent closures, or shifting production abroad – perhaps to China – as the only way to survive under these hyper-competitive conditions caused in significant part by China's artificial currency advantages. This loss of flexibility is another cost that the U.S. industry suffers due to China's currency regime and one that is often overlooked because it is either difficult or controversial to quantify.

F. U.S. Exports to China Are Falling Behind

China's currency policies are also affecting U.S. exports, because the yuan's undervaluation affects the prices of U.S. goods in yuan in China's market. This point is often lost in observations that U.S. exports to China have been rising at a good rate in percentage terms and more quickly than the overall rate of increase by U.S. exports.

A different picture emerges, however, when U.S. export growth to China is viewed in the context of the overall growth in China's imports, which reached 36 percent in 2004, for example. Imports from the United States were the slowest-growing compared with imports from China's largest foreign suppliers. According to China's data, the U.S. share of China's total imports in 2004 actually declined to a new low at only 8.0 percent of total imports, compared to a share of 12.1 percent as recently as 1998. In fact, if its share had not fallen, U.S. exports to China would have been $35 billion higher in 2004 than they actually were – a significant difference of about 50 percent.

This trend is evident in China's third largest category of manufactures imports -- optical and medical equipment – in which imports from the United States rose by 23 percent in 2004,

while China's total imports surged by 60 percent. Once again, between 2001 and 2004, the U.S. share of this important category plunged from 25 percent to 9 percent.

Clearly the United States is not sharing proportionately in China's otherwise robust import growth, and China's currency peg against the U.S. dollar is a prime factor in the United States' under-performance in the Chinese market. The fact that China imports about 50 percent more from the European Union than from the United States confirms this detrimental impact to be the case.

G. U.S. Affiliates Are Not Causing the Import Surge From China

Foreign direct investment plays a large role in China's exports. According to the Congressional Research Service, slightly over 50 percent of China's total exports are produced by foreign-owned enterprises. These foreign-owned firms appear to have accounted for about two-thirds of China's overall export growth since 1994. Some observers mistakenly extrapolate these data to conclude that the bulk of U.S. import growth from China originates from U.S.-owned production in China. In actuality, data from the U.S. Department of Commerce show that imports from U.S. affiliates in China account for only a small amount of total U.S. imports from China.

A 2001 report by the Commerce Department's Bureau of Economic Analysis on U.S. Foreign Direct Investment Abroad[91] indicates that U.S. manufacturing affiliates in China shipped $2.9 billion of goods to the United States in 2001. This was only 3 percent of the $99.7 billion of manufactured goods imported by the United States from China in that year. While this number is viewed with skepticism by many, it is believed that this report remains the only official data published by the U.S. government that are directly relevant to this issue. As such,

[91] See Table II.I.19, Operation of U.S. Parent Companies and Their Foreign Affiliates, 2001.

there is no official basis for claims that the vast bulk of U.S. affiliates' production in China is exported back to the United States and is, therefore, a primary driver of surging U.S. imports from China.

The only other known source of U.S. government data on this subject is the Census Bureau's annual report on "Related Party Trade." This report reveals the extent of U.S. export and import trade conducted by related parties -- i.e., by parents and their related affiliates. This report indicates that only 20 percent of total U.S. imports from China reflect shipments to all multinationals located in the United States from their affiliates in China. This percentage, however, covers all related-party trade, rather than that solely from U.S.-owned multinationals. Thus, this percentage includes, for example, all imports into the United States by Japanese multinational firms from their affiliates in China. Moreover, because the bulk of foreign investment in China is sourced from Hong Kong, Taiwan, and Japan, it is only logical to infer that the bulk of such related-party imports into the United States is from foreign-owned multinationals rather than U.S.-owned multinationals.

In conclusion, therefore, the available data suggest that 20 percent of total U.S. imports from China is the absolute ceiling for the portion that can be attributed to U.S.-owned multinationals, while 3 percent of total imports is the most accurate direct measure available.

H. Country of Production Is Important

The analysis above confirms that a portion of total U.S. imports from China indeed is displacing imports from other countries and that an increase in the value of China's currency might shift some of China's production back to other countries rather than to the United States. The fact that production might not shift directly back to the United States, however, does not mean that the United States would fail to accrue any benefit. Moreover, this conception ignores

the broader fact that if the production does not belong in China based on unfettered economic merit, speculation on where the production might then shift is irrelevant.

There are several reasons why the U.S. economy and U.S. production would benefit even if China-based production activities do not return directly to the United States. For example, Mexico also has been a significant casualty in the shifting of production to China, some of which served the U.S. market and now is shipped back to the United States from China instead. If some of that production returned to Mexico, it would cause an automatic gain in the U.S. trade account, because Mexico imports proportionately more from the United States than China does. For every additional U.S. dollar China earns from the United States and spends somewhere in the world, it is likely to spend only 8 cents in purchasing U.S.-made products (the United States has an 8-percent share of China's imports). In contrast, the United States has more than a 70-percent share of Mexico's imports of goods and services, such that for each additional U.S. dollar Mexico earns in the United States, it is likely to spend 70 cents in purchasing U.S.-made products.

Moreover, the United States' relative competitiveness against Mexico, in this example, would be improved under the presumption that the production originally shifted from Mexico to China for cost reasons (of which China's currency undervaluation might be a significant reason). If production returned to Mexico without the benefit of a grossly undervalued yuan, the competitiveness of U.S.-based production would improve. Thus, even if the actual production does not return to the United States, U.S. producers stand a much better chance of success than if they have to compete with Chinese producers that can lever their undervalued currency into pricing power in export markets.

Finally, the controlled Chinese currency is a major factor behind other Asian countries' interventions to prevent their currencies from reflecting fair market values so as not to be competitively disadvantaged by China in the U.S. and other export markets. For example, an April 4, 2004, Reuters report stated at that time that "[a]ny move by China to revalue the yuan -- currently effectively fixed around 8.28 yuan per dollar -- would enable Malaysia to revalue the ringgit without sacrificing trade competitiveness." This concept is equally and broadly true today. While China is hardly the only country in the region amassing U.S. dollar-based reserves with the result that its export competitiveness is artificially improved, the extent of the Chinese government's intervention coupled with the aggressiveness of its export sector undoubtedly has fueled the practice among China's chief export competitors in the region such as Korea and Taiwan.

I. China's Currency Is Affecting Global Trade Negotiations

The goals of the United States in terms of achieving greater access to markets around the world are also being affected by China's currency policy. Other developing nations, which tend to have the highest tariffs, are reluctant to cut their tariffs for fear of Chinese competition. The European Union's Trade Commissioner, Pascal Lamy, drove this point home in a December 3, 2003, speech to the European Institute, when, in explaining the failure of the WTO's Ministerial meeting in Cancun, Mexico, during September 2003 he said:

> Then there was China. Sometimes it seems as if the U.S., with the tough rhetoric about the need to reduce the trade deficit over the last weeks, is the only country concerned about China. But I don't think that is right. Clearly, no one likes to say it, but many developing countries in particular are concerned about China's seemingly limitless capacity to produce and seemingly bottomless comparative advantage. In other words, if you are already worried about China's ability to scoop the pool, indeed perhaps the phrase is to dredge the pool, the last thing you want is trade liberalisation.

J. Relative Wages Are Not a Principal Factor

A common justification for China's rapid export growth is its significant advantage in labor-cost competitiveness. While low labor costs are certainly a key factor in some manufacturing operations, China is hardly the only country with low wages, and low wages per se are not sufficient to explain China's phenomenal export growth, particularly if productivity differences are taken into account.

In the United States, the cost of labor is a relatively small fraction of the total cost of manufacturing. Direct labor costs – production workers' wages and benefits – constitute only 11 percent of the total cost of manufacturing. While this ratio varies among industries, average labor costs in the United States simply are not significant enough by themselves to explain China's explosive export growth. Moreover, a significant portion of China's nominal labor-cost advantages is offset by significantly higher transportation costs, which typically constitute 10 percent of the product price.

In marked contrast, a 20- to 40-percent undervaluation of the yuan provides a comparatively huge benefit to Chinese exporters, because it affects the entirety of the final Chinese export prices, rather than merely a given cost component, and similarly reduces any ad valorem taxes, tariffs and other charges that are applied to such exports en route to U.S. customers.

K. The Undervalued Yuan Also Adversely Affects U.S. Service Suppliers

The undervaluation of the yuan not only has a negative impact on trade in manufactured products, but also on services. First, a multiplier effect exists between manufacturing and intermediate activities such as services. Every dollar of a manufacturing product sold to a final user generates an additional $1.43 of intermediate economic output, more than half in sectors outside manufacturing, which support several million more U.S. jobs. Second, the

undervaluation of the yuan adversely affects service providers and exporters in the same way it adversely affects manufacturers -- by valuing those services at higher prices than would prevail under unfettered market conditions and by artificially boosting investment by service suppliers in China.

L. Summary

The evidence and analysis presented in this section provide objective and compelling support that China's currency policy is seriously undermining U.S. commerce, jobs, and production. China's undervalued yuan is playing a central role in generating a huge trade deficit by the United States with China, the largest bilateral trade deficit in history. This trade deficit is growing at an alarming rate and can reasonably be expected only to increase at the expense of the United States as long as China does not correct the yuan's undervaluation. A deficit of this magnitude is certainly not sustainable for the United States and is having an extremely debilitating effect on the strength and resilience of the U.S. economy.

V. CONCLUSION

As this petition demonstrates, China's undervalued-exchange-rate regime violates fundamental international legal obligations undertaken by the Chinese government in its capacity as a Member of the World Trade Organization and of the International Monetary Fund. As this petition also demonstrates, China's policy of substantially undervaluing and manipulating the yuan is unjustifiably severely burdening and restricting U.S. commerce. This petition accordingly seeks the immediate elimination of the undervaluation of the yuan. If China refuses to eliminate the undervaluation, the Bipartisan China Currency Action Coalition petitions for the United States to pursue a formal dispute settlement action under the World Trade Organization. If such action is successful, and China does not bring its policies into conformity with its WTO obligations, the United States should pursue WTO-consistent remedies against China.

Respectfully submitted,
{See Signature Page}

Attachment
Exhibits

May 10, 2007

ATTACHMENT

Table of Contents

1. China's Maintenance of An Undervalued Exchange-Rate Regime Violates Article I of the GATT and the Principle of Most-Favored-Nation ("MFN") Treatment

Article I:1 of the GATT sets forth the fundamental obligation of the non-discriminatory axiom of MFN treatment that each Member State must accord to all other Member States. It provides:

> With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III, any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

GATT Art. I:1 (addendum omitted; emphasis added).

With reference to Article I:1, China's policy of effectively pegging the yuan to the U.S. dollar so as to maintain an undervalued yuan vis-à-vis the U.S. dollar is both a rule and a formality in connection with importation and a matter referred to in Article III:4 of the GATT. In the latter regard, as addressed in the section below on national treatment, Article III:4 requires that all laws, regulations and requirements affecting the internal sale, offering for sale, purchase, . . . distribution or use of goods in China not treat imports less favorably than Chinese-origin products. Accordingly, under Article I:1 of the GATT, China is required by the MFN principle to ensure that its currency policy does not discriminate among its trading partners either in connection with the importation of goods into China or thereafter. In particular, a violation of Article I:1 is established if there is (1) an advantage (2) of the type covered by Article I:1 that is

accorded to products from one country or group of countries, but (3) that is not accorded immediately and unconditionally to like products from all WTO Member States.[1] Moreover, Article I:1's prohibition against this sort of discrimination includes both de jure and de facto discrimination.[2]

China's maintenance of an undervalued exchange-rate regime confers an advantage upon third countries whose currencies are not pegged to the U.S. dollar. More specifically, China's undervalued exchange-rate regime prevents the yuan from fluctuating versus the U.S. dollar with the consequence that any third country will benefit when its currency weakens against the U.S. dollar. Such a country will be advantaged by China's effective peg to the U.S. dollar, because its exports to China will become less expensive in terms of yuan-denominated prices and hence more competitive in China. As a result, any country whose currency falls in value compared to the U.S. dollar is provided a significant trade advantage over the United States, because the relative value of the U.S. dollar remains unchanged versus the yuan. Both Brazil and Mexico, for instance, have seen their exports to China increase significantly in recent years due to the weakening of their respective currencies versus the U.S. dollar, even as the trade deficit of the United States with China has continued to expand rapidly. Conversely, the United States can gain no trade advantage with China when the dollar depreciates because of China's undervalued exchange-rate regime.

The benefit obtained by countries such as Brazil and Mexico when their currencies weaken against the U.S. dollar is an "advantage" prohibited under Article I:1. Both in

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[1] See Panel Report, Indonesia – Certain Measures Affecting the Automobile Industry, adopted July 23, 1998, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, at para. 14.138.

[2] See, e.g., Appellate Body Report, Canada – Certain Measures Affecting the Automotive Industry, adopted June 19, 2000, WT/DS139/AB/R, WT/DS142/AB/R, at para. 78.

connection with the importation of goods into China and with their sale and distribution after importation, products from countries whose currencies have fallen in value against the U.S. dollar are more attractive and affordable for Chinese customers than U.S. imports. This phenomenon occurs because the yuan is automatically strengthened against the third countries' currencies, but not against the U.S. dollar, due to China's effective pegging and undervaluation of the yuan to the U.S. dollar. Most emphatically, therefore, the advantage granted to other countries by means of China's undervalued exchange-rate regime is not accorded immediately and unconditionally to like products from the United States. In violation of Article I:1 of the GATT, China wrongly discriminates against U.S. exports to China by depriving the United States of the advantage of the fluctuations in a flexible exchange rate that adjusts to market conditions and that U.S. products would otherwise enjoy.

2. China's Maintenance of An Undervalued Exchange-Rate Regime Is Contrary to Article II of the GATT and Article 9.1 of the WTO Customs Valuation Agreement

a. Background

In fashioning its customs system, China has chosen to determine the amounts of normal duties owed on imports of goods into China by means of ad valorem tariffs. These tariffs are set either at a preferential MFN percentage or at a higher general percentage.[3] In either instance, the percentage is applied against the entered, C.I.F. value of the imported goods expressed in yuan, so that the normal duties owed are paid in yuan.[4] While China's selection of ad valorem tariffs in itself is not problematic, China's undervalued exchange-rate regime -- in combination with its ad valorem methodology -- impairs China's tariff concessions to the United States.

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[3] See Exhibit 6, Bulletin International des Douanes, Year 2000-2001, China (People's Republic of), Organ of the International Union for the Publication of Customs Tariffs, Number 13, 8th ed. (Mar. 2001).

[4] See id., at Arts. 4, 21.

As an example of the ill effects of this interaction, consider the situation in which a U.S. product with a C.I.F. price of $100 is imported into China from the United States. Under a rate of 7.82 yuan to the U.S. dollar and under Articles 4 and 21 of China's previously referenced customs law, that product's entry value will become 782 yuan. Thereafter, if the ad valorem tariff rate is, for example, 10 percent, the consignee in China of the imported U.S. product will be obligated to pay customs duties of 78.2 yuan to the Chinese customs authorities.

Now assume that the yuan had not been undervalued, but had been valued realistically against the U.S. dollar and that the rate of exchange at the time the U.S. product is imported into China consequently is 4.70 yuan to the U.S. dollar. Under this scenario, the U.S. product's C.I.F. price of $100 will become only 470 yuan, and the 10-percent ad valorem tariff will give rise to customs duties for the Chinese consignee of just 47 yuan. These changes would be attributable solely to an upward revaluation of the yuan vis-à-vis the U.S. dollar.

b. Article II of the GATT and Article 9.1 of the Customs Valuation Agreement

Article II of the GATT addresses the schedules of tariff concessions made by the WTO's Member States, while Article 9.1 of the Agreement on Implementation of Article VII of the GATT ("Customs Valuation Agreement") concerns how customs value is to be determined for imports when the conversion of currency is necessary. More precisely,

- Article II:1 makes clear that "ordinary customs duties" and "all other duties or charges of any kind" in excess of a Member State's bindings are forbidden.
- Article II:3 correspondingly stipulates that no Member State shall alter its method of converting currencies so as to impair the value of any of its tariff concessions.
- Article II:6(a) elaborates that the bound specific duties and charges of a Member State that is also a member of the IMF may be adjusted to take account of a

reduction in the par value of that Member State's currency as long as (1) the par value is reduced consistently with the IMF's Articles of Agreement by more than twenty per cent and (2) the WTO's Member States, acting jointly under Article XXV of the GATT, concur that such adjustments will not impair the value of the Member State's tariff concessions, "due account being taken of all factors which may influence the need for, or urgency of, such adjustments." As noted next in subsection (c) below, the modalities for the application of Article II:6(a) as to specific duties and charges were adjusted in 1980 to reflect changes in the international monetary system.

- Finally, Article 9.1 of the Customs Valuation Agreement reads in pertinent part that "{w}here the conversion of currency is necessary for the determination of the customs value, the rate of exchange to be used shall be that duly published by the competent authorities of the country of importation concerned and shall reflect as effectively as possible . . . the current value of such currency in commercial transactions in terms of the currency of the country of importation." (Emphasis added.)

c. China's Maintenance of An Undervalued Exchange-Rate Regime Impairs the Value of Its Tariff Concessions to the United States and Unacceptably Distorts the Customs Value of U.S. Products Imported Into China

From the example described in subsection (a) above, it is evident that a commercially realistic rate of exchange between the yuan and the U.S. dollar, by reflecting the true strength of the yuan, would significantly reduce the customs duties imposed on imports of merchandise into China from the United States, from 78.2 yuan to 47 yuan in the cited instance. China's extreme undervaluation of the yuan directly and dramatically increases the cost in yuan of U.S. products

entering China. From the vantage of the importer in China, therefore, China's undervalued exchange-rate regime compounds the difficulty and expense of importing U.S. products into China by resulting in both a higher purchase price and higher tariffs than would be the case if the exchange rate were to appreciate based on economic fundamentals.

As summarized above, bound tariffs under Article II:1 of the GATT are not to be exceeded, and Article II:3 of the GATT reinforces this axiom by prohibiting a Member State from impairing the value of its tariff concessions through alteration of its method of converting currencies. By definition, to impair something is to diminish its value. From a U.S. perspective, therefore, the value to the United States of China's ad valorem tariff bindings has been impaired due to China's currency interventions designed to prevent the yuan from reaching its unfettered, market-driven equilibrium in relation to the U.S. dollar. For the same reason, with reference to Article 9.1 of the Customs Valuation Agreement, the yuan's rate of exchange does not reflect "as effectively as possible" the yuan's current value in commercial transactions.

The practical effect of the undervalued yuan is to inflate in absolute terms the number of yuan necessary to clear customs and actually enter merchandise from the United States into China. Were China to revalue the yuan upward, the result would be customs duties of far fewer yuan. By the same token, a commercially realistic rate of exchange for the yuan against the U.S. dollar would reflect, "as effectively as possible," the yuan's current value and strength in commercial transactions and thus yield an acceptable determination of customs value for imports into China from the United States.

In short, an appreciation of the yuan against the U.S. dollar is required under Article II of the GATT and Article 9.1 of the Customs Valuation Agreement. The fact that China's customs duties are expressed initially in ad valorem terms rather than as specific duties (that is, so many

yuan per unit or quantity of imported product) should not make any difference here. It is those ad valorem percentages that are applied against the inflated values in yuan of imports from the United States and that thereby yield similarly inflated customs duties in yuan and thus violate China's tariff bindings.[5]

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[5] In May 1978, a Working Party was formed to examine how Article II:6(a) of the GATT should be applied in light of the amendment that took place in April 1978 to the Articles of Agreement of the IMF. That amendment acknowledged that the IMF's members were no longer obliged to maintain par values for their currencies and recognized the right of the IMF's members to adopt exchange arrangements of their choice, including floating exchange rates and exchange rates fixed against another currency, a basket of currencies, or an international unit of account. As the Working Party explained, the basic purpose of Article II:6(a) is to permit adjustment of bound specific duties to take into account the inflationary erosion or depreciation of a contracting party's currency in which the specific duties were defined. See Specific Duties: Report of the Working Party, adopted Jan. 29, 1980, L/4858, BISD 27S/149, 150 ("Specific Duties").

In the course of its analysis, the Working Party briefly considered the situation in which a currency's appreciation causes a decline in import prices and an increase in the ad valorem incidence of specific customs duties. At the same time, the Working Body commented, the lower import prices normally would lead to a decline in the competitiveness of the domestic industry and greater import penetration. After opining that in neither case would impairment occur as to the competitive opportunities resulting from specific duty concessions, the Working Party agreed not to pursue this matter, noting that Article II:6(a) does not deal with currency appreciations and that dispute settlement could be pursued by a contracting party that considered the value of specific duty concessions impaired by currency appreciation in a particular case. See Specific Duties, BISD 27S/149, 150.

For the reasons articulated in the accompanying text above, it is submitted that the reasoning underlying the Working Party's evaluation concerning the effects of currency fluctuations on specific customs duties reinforces the conclusion that China's imposed undervaluation of the yuan impairs the value of China's ad valorem tariff bindings to the United States. Were the yuan realistically revalued upward, an importer in China of U.S. goods would pay considerably less in customs duties than presently with the yuan so depressed vis-à-vis the U.S. dollar.

3. China's Maintenance of An Undervalued Exchange-Rate Regime Inflates the Value In Yuan of Dollar-Denominated Imports Into China From the United States, Thereby Discriminating Against U.S. Imports In Favor of Lower-Priced Chinese Products, Contrary to the Principle of National Treatment Under Article III of the GATT

Article III of the GATT – the so-called "national-treatment" clause – stipulates that imported products are to be treated no less favorably than domestically-produced like products. Specifically, Article III:4 provides that:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favorable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

GATT, Art. III:4 (emphasis added). Notably, this broad ban against discriminatory treatment of imports makes no reference to the government's motives or purposes in giving disparate treatment to imported products. Rather, the only prerequisites for a violation to be shown under this provision are that a law, regulation, or requirement (1) affect the internal sale of an imported product and (2) accord less favorable treatment to the imported products than to domestic like products.

With respect to the first criterion, it is clear that China's manipulation and undervaluation of its currency vis-à-vis the U.S. dollar do affect the "internal sale, offering for sale, purchase, . . . distribution or use" of imported products from the United States. By means of aggressive, internal currency controls and intervention in currency markets to maintain an undervalued yuan vis-à-vis the U.S. dollar, China ensures contrived, inflated values in yuan of dollar-denominated imports into China. Consequently, conversion into yuan of the value of the U.S. imports into China effectively imposes a tax on the U.S. goods in the amount by which the yuan is undervalued.

For example, undervaluation of the yuan by 40 percent vis-à-vis the U.S. dollar increases a Chinese importer's purchase price for the U.S. product in yuan by 40 percent. For all practical purposes, the yuan's 40-percent undervaluation is the equivalent of a 40-percent tax on U.S. imports into China and, thus, a 40-percent distortion in relative prices in favor of Chinese-origin products. Thus, under Article III:4 of the GATT, China's policy of manipulating its currency so as to maintain an undervalued yuan vis-à-vis the U.S. dollar constitutes a "law[], regulation[], and requirement[] affecting the[ ] internal sale, offering for sale, purchase, . . . distribution or use" of imported products from the United States.

Likewise, the second criterion of Article III:4 is satisfied because China's policy of maintaining an undervalued yuan vis-à-vis the U.S. dollar treats imported U.S. products less favorably than Chinese domestically produced products. China's currency measure discriminates against the sale of U.S. products in China by artificially inflating their yuan-denominated prices in China. This disadvantage for U.S. products is aggravated by the application of China's internal ad valorem taxes, such as the value-added tax ("VAT"), against the excessive yuan-denominated value of the U.S. merchandise. The result is that China's currency policy unfairly discriminates against the sale of U.S. products in China in favor of lower-priced Chinese domestic products. This treatment of U.S. products is less favorable than that accorded to Chinese products and so is in violation of Article III:4 of the GATT.

The denial of national treatment by China's policy of depressing the value of the yuan versus the U.S. dollar can also be seen by recalling the central purpose of Article III, which is to ensure that domestic laws and regulations affecting the internal sale of products are not "applied to imported or domestic products so as to afford protection to domestic production." GATT, Art.

III:1 (emphasis added). In Japan – Alcoholic Beverages, the WTO's Appellate Body explained the purpose of Article III in the following terms:

> The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III "is to ensure that internal measures 'not be applied to imported or domestic products so as to afford protection to domestic production.'" Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products. "[T]he intention of the drafters of the Agreement was clearly to treat the imported products in the same way as the like domestic products once they had been cleared through customs. Otherwise indirect protection could be given".

Appellate Body Report, Japan – Taxes on Alcoholic Beverages, adopted Nov. 1, 1996, WT/DS8/AB/R, WT/DS10/ AB/R, WT/DS11/AB/R, at 15-16 (citations omitted).

In the case of China, it is important to remember that the severe and persistent undervaluation of the yuan is accomplished by the Chinese government's currency controls, such as specific limitations or restrictions on foreign-exchange holdings, as well as even stricter restrictions or prohibitions on investment activities by both foreign and domestic firms. As a result of these restrictions and prohibitions, an excess supply of foreign-exchange/dollars occurs in the Chinese market that must be absorbed by the Chinese government through intervention in the foreign-exchange market.

Contrary to Article III:4 of the GATT, China's currency controls and intervention in the foreign-exchange market are internal measures that adversely affect the sale of U.S. products in China by means of the severe and persistent devaluation of the yuan vis-à-vis the U.S. dollar. As remarked above, the impact of these currency controls and intervention is like that of an additional tax on any U.S.-made goods sold in China. Such measures are different than a tax levied at the border on imported merchandise. While the conversion from U.S. dollars to yuan is

computed at the time of importation, the conversion itself is just the manifestation of China's strict currency controls and intervention scheme. These mechanisms used by China to manipulate its foreign-exchange rate so as to maintain a severely undervalued yuan vis-à-vis the U.S. dollar are themselves implemented internally in China and are not border measures.

Additionally, China's currency controls and intervention in the currency market most assuredly negatively affect the sale of U.S. products in China within the meaning of Article III:4, because these measures constitute a law or regulation that "adversely modif[ies] the conditions of competition between the domestic and imported products on the internal market."[6] In particular, the Chinese government's currency controls discriminate against U.S. products and benefit Chinese products by artificially making the U.S. products more expensive for Chinese consumers. The resultant handicapping due to the inflated, yuan-denominated prices of U.S. products is further magnified by the amount of yuan collected from the assessment of all other ad valorem taxes, such as the VAT.

Accordingly, China's policy of manipulating its currency clearly discriminates against all U.S. products and in favor of Chinese products and withholds national treatment from U.S. products in contravention of Article III of the GATT.

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[6] See Panel Report, Italian Discrimination Against Imported Agricultural Machinery, adopted Oct. 23, 1958, BISD 7S/60, para. 12 (With respect to Article III:4, "{t}he selection of the word 'affecting' would imply, in the opinion of the Panel, that the drafters of the Article intended to cover in paragraph 4 not only the laws and regulations which directly governed the conditions of sale or purchase but also any laws or regulations which might adversely modify the conditions of competition between the domestic and imported products on the internal market.").

4. China's Maintenance of An Undervalued Exchange-Rate Regime Violates Article XI of the GATT

a. Background

Article XI of the GATT is another of the fundamental pillars of the global trading system. Whereas Articles I and III of the GATT are designed chiefly to overcome discrimination against imports through MFN and national treatment, respectively, Article XI addresses this problem by generally eliminating the blunt instrument of quantitative restrictions on imports. As relevant, Article XI.1 provides that "[n]o prohibitions or restrictions other than duties, taxes, or other charges, whether made effective through quotas, import . . . licenses or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party . . . ." As this language indicates, Article XI:1 is far-reaching in its scope,[7] and what few exceptions there are under Articles XI:2 and XX of the GATT are limited. Moreover, a measure that falls under Article XI:1 constitutes an impermissible restriction on imports under that provision, whether or not the measure actually has impeded imports, because the GATT's basic provisions have consistently been interpreted as being intended to establish and maintain conditions of competition.[8]

b. China's Maintenance of An Undervalued Exchange-Rate Regime Is a Measure That Wrongly Acts As a Restriction on Imports Into China

It is only by the concerted efforts of the Chinese government and the currency controls employed by China that the yuan has become and remains so severely undervalued vis-à-vis the

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[7] See, e.g., Panel Report, Japan -- Trade in Semi-Conductors, L/6309, adopted May 4, 1988, BISD 35S/116, 153-54, at paras. 104, 106 (Article XI:1's wording is comprehensive and refers not to laws or regulations, but more broadly to all measures other than duties, taxes or other charges that restrict the importation of products).

[8] See, e.g., Panel Report, European Economic Community – Payments and Subsidies to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, adopted Jan. 25, 1990, BISD 37S/86, 130, at para. 150 ("EEC – Oilseeds").

U.S. dollar. Under any reasonable standard, these actions taken together are a measure within the meaning of Article XI:1 of the GATT. Furthermore, this measure is not a duty, tax, or other charge of the sort that Article XI:1 permits.[9]

In addition, the yuan's undervaluation runs counter to Article XI:1 because this measure restricts the importation of U.S. products into China. While the GATT's jurisprudence on this subject holds that a measure need not be shown actually to have impeded imports to be inconsistent with Article XI:1,[10] China's undervaluation of the yuan not only has upset the conditions of competition between China and the United States, but has precluded large quantities of U.S. products from being exported to China, as China's enormous, extended, and growing current-account surplus with the United States attests.

The restrictive impact of China's undervalued yuan on the volume of imports into China from the United States is analogous to the limiting effect caused by a minimum price system administered by the European Community during the 1970s for certain processed fruits and vegetables. Under that program, affected fruits and vegetables valued below the minimum price established by the European Community were not permitted to be imported. This minimum import price system, as enforced by a requirement of additional security, was found to be an

[9] At the same time, as described in the sections earlier on Articles II and III of the GATT, the yuan's undervaluation should be seen as resulting in what effectively amounts to violative charges in excess of China's tariff bindings and internal taxes that discriminate against imports from the United States in favor of Chinese domestic products. These comparisons, however, do not mean that China's currency controls and undervaluation of the yuan are themselves duties, taxes, or other charges. They are not, and so Article XI:1 of the GATT is also contravened by China's actions.

[10] See EEC – Oilseeds, BISD 37S/86, 130, para. 150.

impermissible restriction other than duties, taxes, or other charges within the meaning of Article XI:1.[11]

China's undervaluation of the yuan similarly works to restrict imports into China from the United States by inflating the yuan-denominated prices of U.S. products. Were the yuan's rate of exchange with the U.S. dollar realistically revalued upward, the yuan-denominated prices of U.S. products would be less than is currently the case. The yuan's undervaluation consequently acts as the European Community's rejected minimum price system did by raising the yuan-denominated prices of U.S. products and thus restricting the importation of those goods.

For these reasons, China's extreme undervaluation of the yuan should be considered to be a measure that restricts the importation of U.S. products into China and hence violative of Article XI:1 of the GATT.

5. Even If China's Maintenance of An Undervalued Exchange-Rate Regime Does Not Violate Other Provisions of the GATT, That Behavior Nullifies or Impairs Benefits of the United States Within the Meaning of Article XXIII:1(b) of the GATT

a. Background

Article XXIII:1(b) of the GATT recognizes that benefits accruing to one Member State from another Member State can be nullified or impaired by the latter's actions even when those actions might not violate some other provision of the GATT. Put otherwise, a Member State's legitimate expectations of improved competitive opportunities can be unrealized even by measures of another Member State that are consistent with the GATT as well as by measures that

[11] See Panel Report, EEC – Programme of Minimum Import Prices, Licences {sic} and Surety Deposits for Certain Processed Fruits and Vegetables, adopted Oct. 18, 1978, BISD 25S/68, 99, para. 4.9.

are not consistent with the GATT.[12] While this somewhat unusual remedy is to be approached with caution and is exceptional,[13] Article XXIII:1(b) dates from 1947 and is well-rooted in the GATT's jurisprudence. Claims of so-called non-violation nullification or impairment under Article XXIII:1(b) historically have concerned circumstances in which GATT-consistent domestic subsidization of a product has been introduced or modified following the grant of a tariff concession on that product, but it is not inappropriate to apply Article XXIII:1(b)'s remedy to other governmental actions.[14]

In essence, Article XXIII:1(b) reads that a claim may be made in dispute settlement

> {i}f any Member State should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of . . . (b) the application by another Member State of any measure, whether or not it conflicts with the provisions of this Agreement . . . .

Thus, there are three main components that must be demonstrated for a cognizable claim under Article XXIII:1(b): (1) application of a measure by a Member State; (2) a benefit accruing under the relevant agreement; and (3) nullification or impairment of the benefit as the result of the application of the measure.[15] More broadly, it is important to keep in mind that the inclusion of Article XXIII:1(b) in the GATT reflects the GATT's function of establishing conditions of competition and the protection of trading opportunities for merchandise. The GATT involves

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[12] Appellate Body Report, European Communities – Measures Affecting Asbestos and Asbestos-Containing Products ("EC – Asbestos"), WT/DS135/AB/R, adopted Apr. 5, 2001, para. 185 (citing EEC – Oilseeds, BISD 37S/86, adopted Jan. 25, 1990, para. 144).

[13] EC – Asbestos, WT/DS135/AB/R, paras. 185 and 186 (citing Japan -- Film, WT/DS44/R, adopted Apr. 22, 1998, para. 10.37).

[14] See Japan -- Film, WT/DS44/R, para. 10.38.

[15] See Japan -- Film, WT/DS44/R, para. 10.41. Further, Article 26.1(a) of the WTO's Dispute Settlement Understanding ("DSU") stipulates that the complainant Member State must present "a detailed justification" in support of its position.

both a carefully negotiated balance of the interests of the Member States and a mutuality of obligations and rights. To the extent that, with the passage of time, the underlying situation might change or the benefits accorded any party might be impaired, the balance would be destroyed. Along with the other sections of Article XXIII, therefore, the goal of Article XXIII:1(b) is not retaliation and sanctions, but the restoration or the maintenance of the balance of interests once established.[16]

b. China's Maintenance of An Undervalued Exchange-Rate Regime Vitiates the Obligations of China to the United States and Thereby Has Disrupted the Carefully Negotiated Balance of Interests Between the Two Countries

By maintaining an undervalued exchange rate for the yuan against the U.S. dollar, China is undercutting its commitments to the United States and depriving the United States of the full benefit of the bargain the two nations struck upon China's accession to the WTO in December 2001.

Application of a measure by the Government of China -- With reference to the elements of a claim under Article XXIII:1(b), China's currency exchange regime is a measure applied by China. As discussed elsewhere in this petition in greater detail, it is only by means of carefully controlled mechanisms and deliberately executed procedures and currency controls that the Chinese government is able to maintain the yuan's effective peg to the U.S. dollar. The expansive language of Article XXIII:1(b) makes clear that these mechanisms, procedures, and

[16] See E. Petersmann, The GATT/WTO Dispute Settlement System 136, 144-45 (1997). Consistently within this framework, Article 26.1(b) of the DSU provides that when a claim is upheld under Article XXIII:1(b) the Member State involved is not obliged to withdraw the measure in question, but that in such a case the WTO panel and Appellate Body shall recommend that that Member State make "a mutually satisfactory adjustment."

controls carried out by the Chinese government are a measure that the Government of China is applying.[17]

Benefit accruing to the United States under the GATT – It is evident from the negotiations between China and the United States leading up to China's accession to the WTO that both countries shared the purpose of improved market-access opportunities vis-à-vis each other. Certainly the United States sought as much as possible to open the Chinese market to exports from the United States, and China no less wanted to gain guaranteed market access that derived from Permanent-Normal-Trade-Relations status. These interrelated objectives underlie the balance of interests and the mutual obligations and rights that China and the United States finally negotiated.

Permanent-Normal-Trade-Relations status as well as China's huge and growing trade surplus with the United States are the strongest possible testament that China has realized its goal of achieving guaranteed access for its goods to the U.S. market. On the other hand, U.S. exports to China have not grown dramatically except in selected areas, such as the category of raw materials, and thus the United States has not reaped the intended benefit of its bargain with China and does not have the same sort of easy access for its goods to the Chinese market that Chinese exporters have for their goods to the U.S. market.

In keeping with the requirements of Article XXIII:1(b),[18] the United States' legitimate expectations were at the time of the negotiations and remain that in principle that China's market

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[17] EC – Asbestos, WT/DS135/AB/R, para. 188 (the reference to "any measure" in Article XXIII:1(b) " . . . suggests that measures of all types may give rise to such a cause of action. The text does not distinguish between, or exclude, certain types of measure.").

[18] See Japan -- Film, WT/DS44/R, para. 10.61 (for expectations of improved market-access opportunities to be legitimate, they must take account of all measures of the party making the concession that could reasonably have been anticipated at the time of concession).

should be open to imports from the United States as the U.S. market should be open to imports from China. This comparable balance does not mean that the United States has now or ever has had expectations of particular export volumes from the United States to China or vice versa, but that the carefully negotiated obligations and rights with respect to China should facilitate a healthy, competitive relationship between imported and domestic products for each country.

This reasonable anticipation by the United States is grounded both in China's concessions during the negotiations generally and in China's representations and comments during the negotiations with regard to foreign exchange and payments more particularly. On the latter score, as the Working Party's Report on the Accession of China describes, China's representative presented a picture of China as having already made considerable progress -- and as intently striving further -- to "reform, rationalize and liberalize the forex market."[19] China's representative also stressed that ". . . since the unification of exchange rates on 1 January 1994, China had adopted a single and managed floating exchange rate regime based on supply and demand."[20]

These remarks and other reassurances were forthcoming from China's representative in response to concerns expressed by some members of the Working Party about China's use of forex controls to regulate the level and composition of its trade in goods and services.[21] Against this background, the United States was justified in expecting from the negotiations that China would not resort to foreign-exchange controls so as to stifle China's trade in imports and instead would adjust its currency-exchange rates in the interests of fostering the mutually beneficial

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[19] See Report of the Working Party on the Accession of China, WT/ACC/CHN/49, at para. 27 (Oct. 1, 2001).

[20] Id. at para. 31.

[21] Id. at para. 27.

conditions of competition and balance of interests envisioned in China's accession agreement.[22] To expect the United States to have recognized at the time of the negotiations that China would prove subsequently, despite its representations to the Working Party, to be so entrenched in effectively pegging its currency to the U.S. dollar would not be fair or realistic. Especially as the U.S. dollar generally has been depreciating in value generally, the United States could not reasonably have anticipated at the time of the negotiations that China's self-described, "managed floating exchange rate regime based on supply and demand"[23] would be effectuated by China to undervalue the yuan so extensively vis-à-vis the U.S. dollar.

Nullification or impairment of the benefit as the result of the application of the measure – The evidence and economic data compiled in other sections of this petition document a trade imbalance of alarming and widening proportions at the considerable expense of the United States and in favor of China. Likewise, there is little real disagreement that the yuan is undervalued; only the extent of that undervaluation is disputed. The causal relationship between the undervalued yuan and China's rapidly increasing trade surplus with the United States is manifest from the basic workings of the U.S. dollar's unnatural strength vis-à-vis the yuan due to the Chinese government's currency manipulation. The resulting competitive disadvantage for high-priced U.S. exports to China thus meets the last prerequisite of Article XXIII:1(b) in GATT jurisprudence, that the relative competitive position of those U.S. products that would be imported into China has been upset (nullified or impaired) to more than a de minimis extent by

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[22] Although China's currency was pegged to the U.S. dollar during China's accession negotiations, knowledge of a measure's existence is not equivalent to understanding the impact of the measure in the future, and so, for example, a vague measure can be given substance through enforcement policies that either are not expected initially or are later significantly changed. See Japan – Film, WT/DS44/R, para. 10.80.

[23] Report of the Working Party on the Accession of China, at para. 31.

China's unanticipated application of its currency-manipulation measure, whether by itself or in combination with other measures.[24]

For the foregoing reasons, China's currency-exchange regime should be found to nullify or impair benefits accruing to the United States and to impede attainment of objectives under the GATT within the meaning of Article XXIII:1(b).

[24] See Japan -- Film, WT/DS44/R, paras. 10.82-10.88. In this connection, it should be noted that Article XXIII:1(b) does not require proof of intent by China to nullify or impair benefits of the United States by its pegging of the yuan. Such intent may not be irrelevant, but need not be shown. See id. at para. 10.87.

EXHIBIT 1

I. CHINA AND ITS UNDERVALUED EXCHANGE-RATE POLICY PRESENT AN EXTREME, IF NOT UNIQUE, CASE OF CURRENCY UNDERVALUATION

A. Classification of Exchange-Rate Regimes

The International Monetary Fund ("IMF") has been the recognized central institution of the international monetary system since its establishment as the result of the historic United Nations conference at Bretton Woods, New Hampshire in 1944. The IMF formally came into existence at the end of 1945 when the 29 original members signed its Articles of Agreement. Both the United States and China were original signatories. The Articles of Agreement established the IMF's responsibilities, which remain the same today and center on promoting four primary goals:

(1) the balanced expansion of world trade;

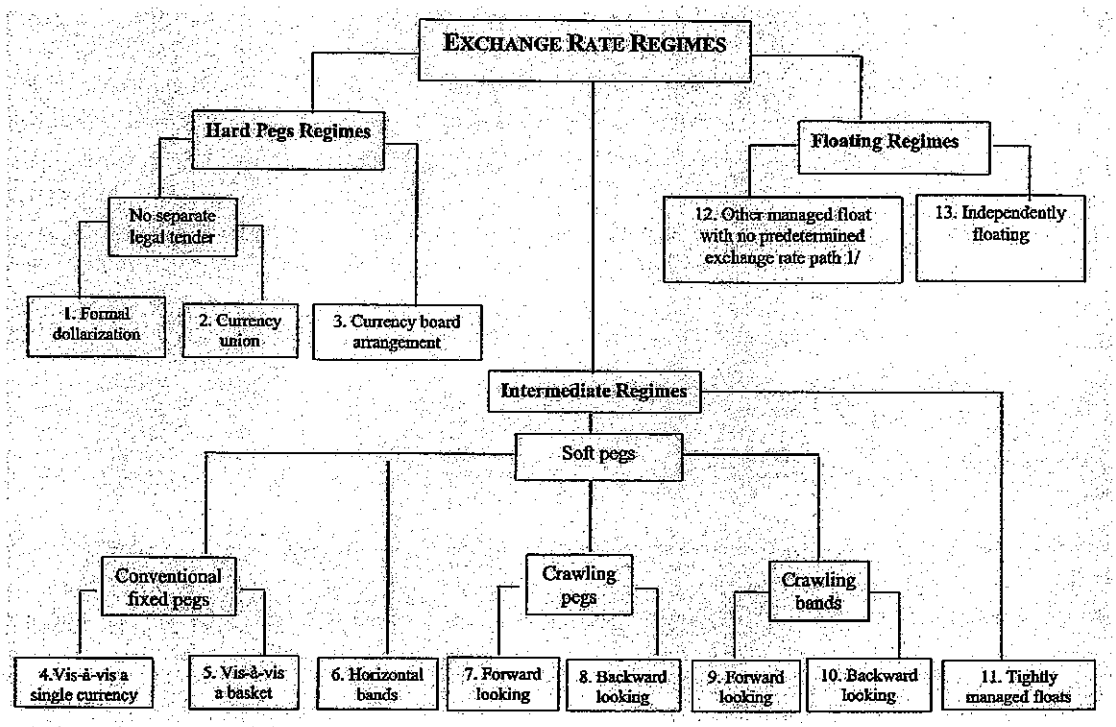
(2) the stability of exchange rates;

(3) the avoidance of competitive currency devaluations; and,

(4) the orderly correction of balance-of-payments problems.

The Bretton Woods conference put in place a system that intermediated payments between countries by regulating the rates of exchange among members' national currencies. The so-called Bretton Woods system defined the relationship among members' currencies using a two-tiered structure: members' currencies (except the U.S. dollar) were set at agreed-upon rates vis-à-vis the U.S. dollar, while the U.S. dollar was valued in terms of gold. The agreed rates between individual member currencies and the U.S. dollar were thus "pegged" subject to adjustment as necessary to correct balance-of-payments problems as allowed by the IMF. Thus, the Bretton Woods system initially was one of essentially fixed rates of exchange among members' currencies.

This system prevailed until 1971, when the United States suspended the convertibility of its currency into gold, including U.S. dollar reserves held by foreign governments. In the aftermath of this fundamental shift, member countries were free to choose any form of exchange arrangement they desired, except the gold standard. Over time, an array of different exchange arrangements developed as the IMF's membership expanded to its current total of 184 countries, which include essentially all of the United States' trading partners. These arrangements are diagrammed below, based on their relative degree of flexibility (i.e., degree of monetary autonomy) and interdependence with other members' currencies.



1/ Excludes tightly managed floats.

Source: Bubula, Andrea and Inci Otker-Robe (September 2002), "The Evolution of Exchange Rate Regimes Since 1990: Evidence from De Facto Policies," International Monetary Fund, IMF Working Paper #02/155 at 14.

The thirteen specific classifications are categorized into three primary groups – hard pegs, intermediate regimes and floating regimes. Hard pegs are considered the most rigid, as

members employing such regimes tend to have the least degree of monetary autonomy.[1] In contrast, floating regimes are considered the most flexible, as the relative values of the national currency are allowed to fluctuate vis-à-vis other currencies as market forces dictate. The intermediate regimes are positioned somewhere in the middle, between the hard pegs and floating regimes.

Although hard pegs and floating regimes lie at opposite ends of the spectrum, neither type of regime is completely "pure" in terms of its rigidity and flexibility, respectively, nor is either group completely free from governmental intervention. For example, the European Monetary Union ("EMU") is the foremost example of a "currency union," which is a hard-peg type of regime. The EMU's members have abandoned their national currencies in favor of the euro as the EMU's separate legal tender. Although each national currency of the EMU countries is fixed in value in relation to the euro, the euro can and does fluctuate freely in value with respect to the currencies of non-EMU countries. Conversely, floating-rate regimes are often subject to management by utilizing governments and can be far from unfettered. Governments may intervene in currency and other financial markets, seeking to limit the volatility in the currency values on occasion, or even attempting to alter their relative values. Such management can be direct in the case of "loosely managed floats," which involve overt actions to alter relative currency values, or it can be indirect in the case of "independent floats" when governments act on an unofficial basis to alter relative currency values. The most common form of intervention involves massive foreign-currency purchases and sales in the open market by central banks

[1] At the extreme, "formal dollarization" avoids the use of a separate national currency altogether and substitutes the U.S. dollar as the recognized money in the country.

seeking to force the relative value of their currency higher or lower than prevailing market values.

Intermediate regimes fall in the middle of the spectrum between hard pegs and floating regimes. Intermediate regimes themselves comprise a continuum of different measures to set, limit and control the relative value of a given currency. Most of the options with intermediate regimes are considered "soft pegs" in that they employ a targeted value for the national currency relative to one or more chosen standard(s), but permit varying but limited degrees of fluctuation around that targeted value.

The least flexible of the soft pegs are "conventional-fixed pegs," which establish a set value for a national currency to either a single foreign currency or a basket of two or more currencies. Typically, a government uses the currency or currencies of its major trading or financial partners in establishing conventional-fixed pegs. The peg is considered "fixed" based on the relatively narrow range of fluctuation (generally $\pm$ 1 percent or less) that is permitted around the set or parity value. Fixed-peg regimes tend to require the greatest degree of intervention and control by monetary authorities in order to maintain the relative value of the currency close to its chosen parity level. "Horizontal bands" are very similar to fixed pegs, but permit a greater range of fluctuation ($\pm$ 1 percent or more) around the targeted parity value.

"Crawling-peg" regimes employ an initial parity value, but involve periodic small adjustments (higher or lower) that are either fixed in amount or automatic based on selected financial indicators, such as relative inflation rates or targeted inflation rates. Finally, "crawling-band" regimes permit both a normal range of fluctuation ($\pm$1 percent or more) around a selected parity value, but also involve periodic small adjustments in the parity value that carry the bands along with it. A distinguishing feature of the crawling-peg and crawling-band regimes is that

they attempt to reduce volatility while permitting the value of the currency to trend slowly in a given direction and/or toward a desired target level.

Prior to 1999, the IMF classified exchange-rate regimes based on the official notifications by its members ("de jure" classification system). In essence, the regime reported to be in use by each member formed the basis of its classification. Beginning in 1999, however, the IMF approved a proposal to move to a "de facto" classification system that relies instead on its staff's judgments as to the actual type of regime being employed by member countries. These judgments focus on each member's commitment to a given exchange-rate path rather than solely on the degree to which exchange rates are permitted to fluctuate and change.[2]

Since shifting to a de facto classification system, the IMF has reported only a limited number of instances in which its staff assessments have differed from the notifications reported by members. It consequently appears that China likely was a precipitating factor in this wholesale change from a de jure to a de facto classification system by the IMF. In 1987, China had notified the IMF that it was employing a "managed-float" regime. In 1999, the year the new de facto classification system was adopted, however, the IMF changed the classification for China to a "conventional-fixed peg."[3] Given the timing and prominence of China among the countries affected by the IMF's change, it seems clear that China was a primary concern of the IMF.

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[2] IMF, *Exchange Arrangements and Foreign Exchange Markets*, 2003 at 5.

[3] See Attachment 1. The current listing of de facto/de jure divergences include: China, Iran, Jordan, Lebanon, Macedonia, Maldives, Saudi Arabia, Sudan, Suriname, Turkmenistan, United Arab Emirates, Zimbabwe, Costa Rica, Romania and Myanmar. By way of comparison, China's gross domestic product is estimated to be approaching U.S. $1.3 trillion, while that of Saudi Arabia, the next largest country in the group after China, is estimated at less than U.S. $200 billion.

History has validated the IMF's classification of China's regime as a conventional-fixed peg, given that the exchange rate between the yuan and the U.S. dollar did not change until a modest nominal revaluation of the yuan on July 21, 2005, and since then has changed very little in real terms and remains effectively a pegged exchange rate. Nevertheless, China has not revised its notification to the IMF and thus has insisted on retaining its de jure classification as a managed-float regime, despite the growing length of time that its actions clearly have been inconsistent with that nominal classification.

B. Appropriateness of a Given Exchange-Rate Regime

Despite an abundance of academic theory and debate on the matter, there are no universally-accepted principles to suggest that any specific exchange-rate regime is necessarily better than another regime. Viewed in the abstract, there are many regime options -- and numerous variations on those options that borrow from each extreme in varying aspects and degrees -- from which a country can choose. Given that all of the available options are then analyzed and adopted by a multitude of countries with unique sets of economic and financial characteristics that change over time, absolute conclusions as to the appropriateness of one regime over another are fragile at best.

The most defensible position is that no single regime is likely better than any other under all circumstances and/or for all countries. Moreover, history has shown that a particular regime that has served a given country well for a certain period of time might not continue to do so when circumstances change. The decision of what exchange-rate regime to select at a given time is difficult at best and has important and far-reaching implications for the subject country's economic stability. Moreover, as economic and financial integration continues to expand globally, one country's choice of exchange regime increasingly affects its trade and financial partners' economic stability as well.

The lack of permanent, optimal solutions reflects both the expansion of global integration economically and financially and the fact that each option has characteristic advantages and disadvantages that come into play as market and economic conditions change. These trade-offs are best illustrated by contrasting the two extremes of the regime groupings available -- hard pegs (e.g., currency unions) and floating regimes, as summarized below.[4]

Regime Type	Advantages/Strengths	Disadvantages/Weaknesses
Hard peg (e.g., currency union)	• credible monetary policy anchor (greater anti-inflation bias) • reduced exchange rate risk • neutralizing of competitive changes	• reduced monetary autonomy and discretion • very limited ability to respond to shocks • greater susceptibility to speculative attacks
Floating regime (e.g., independent or pure float)	• greater monetary autonomy and discretion • greater ability to respond to shocks • Central Bank retains lender-of-last resort capability • less susceptibility to speculative attack	• greater volatility and exchange-rate risk • greater inflationary bias

By focusing on the two extremes, it is evident that the weaknesses of one regime generally constitute the strengths of the other, and vice-versa. As exchange-rate regimes become more flexible, countries gain greater monetary independence but become more vulnerable to exchange-rate volatility. Similarly, as regimes become more rigid, countries achieve greater exchange-rate stability but lose monetary discretion. The intermediate regimes have a hybrid of these advantages and disadvantages, to a degree that depends upon the nature of the particular intermediate regime employed.

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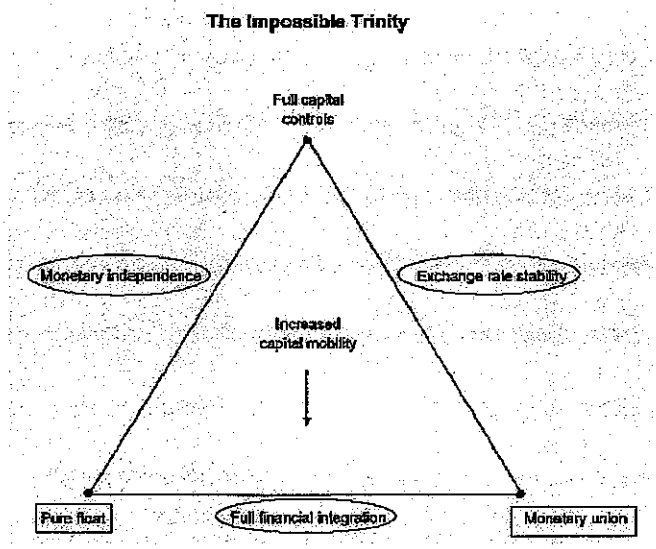
[4] Frankel, Jeffrey A. (September 1999), "No Single Currency Regime is Right for All Countries or at All Times," National Bureau of Economic Research, Working Paper #7338 at 9.

The continuum and trade-offs involved across the different regimes are elegantly illustrated by the principle of the "impossible trinity," below.[5] This principle derives from the notion that countries' international monetary policies seek to attain three basic goals (shown in circles): (1) monetary discretion and independence; (2) exchange-rate stability; and 3) financial market integration. The impossible-trinity principle holds that only two of these three policy goals can be pursued at any time, meaning that one of the goals must be abandoned.



The two currency-regime extremes are shown in the squares at the bottom corners of the triangle – "pure float" and "monetary union." At each of these corners, the adjoining legs of the triangle illustrate the policy goals that can be achieved by that regime option. Thus, the "pure-float" regime (most flexible) can achieve both monetary independence and full financial integration, but not exchange-rate stability. Similarly, the "monetary-union" regime (least flexible) can achieve exchange-rate stability and full financial integration, but not monetary independence. Intermediate regimes lie somewhere in the interior of the triangle, depending on

[5] Frankel at 7-9.

their relative flexibility and the degree of corollary capital controls employed. At their extreme, intermediate regimes that employ full capital controls lie at the apex of the triangle, where monetary independence and exchange-rate stability can be achieved, but at the expense of financial integration.

While these are theoretical concepts, the cases of the United States and China represent nearly perfect paradigms of two of the triangle's three extremes – a pure float and full capital controls, respectively. The radical differences in the regimes employed by each country stand in stark contrast to the close ties that otherwise have been forged between their economies and currencies by virtue of China's effective peg to the dollar. Although theory cannot resolve finally the debate whether such a peg is appropriate, it does suggest the potential for great distortions and pressures, as manifest in the clearly imbalanced trade and financial flows between the two countries. For now, these imbalances have turned the trading relationship in China's favor and are undermining the diversification benefits of global integration. If left unaddressed, however, history has proven that such distortions and imbalances will only intensify, raising the specter of greater volatility, crisis and, in the extreme, contagion.

C. Empirical Evidence on Exchange-Rate Regimes

Although academic theory may provide few absolute answers regarding optimal exchange-rate regimes, there can be little debate about current and historical experience. Rather than speculate regarding an optimal regime, the analysis in this section investigates three simple issues – the regimes that countries are using now, how the use of the various regimes has changed over time, and the recent experience of other countries that use the conventional fixed-peg regime that China effectively employs.

1. Country Composition for Each Exchange-Regime Type

A complete listing of the IMF signatories categorized by regime type, using the de facto classification system, is attached at Attachment 1.

As noted previously, China's regime is classified as a "conventional-fixed peg" and effectively remains such in real terms. Thirty other countries peg their currencies against a single currency, as China effectively does.[6] See Table 1 and Chart 1. As shown, most of these countries are very small, generally lesser-developed, and have insignificant trade flows with the United States. China is a clear exception, accounting for nearly 70-percent of all U.S. trade among these countries. Malaysia is a distant second with a 14-percent share. As shown, only a handful of these countries' data are even visible on the scale needed to accommodate China's data.

While a total of 31 countries peg their currencies to a single foreign currency, ten other countries peg their currencies to a composite or basket of currencies.[7] See Table 2 and Chart 2. Once again, the "basket-peg" countries are very small, generally lesser-developed, have insignificant trade flows with the United States, and are all dwarfed by China. As shown, only Kuwait's data are even visible on the scale needed to accommodate China's data. While many analysts and observers seem to agree that a basket-based peg for the yuan would tend to avoid some of the evident weaknesses in its effective peg to the U.S. dollar, a review of the countries employing this regime does not provide very strong support for this option per se.

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[6] The countries that peg to the U.S. dollar fall loosely into two groupings. The first comprises countries whose economies are relatively small and heavily dependent on the United States for a large portion of their otherwise limited overall trade. The second comprises countries whose exports are dominated by international commodities traded in U.S. dollars, such as oil producers, and who gain considerable stability by pegging to the U.S. dollar. China fails to fit in either of these groupings.

[7] A so-called "basket-peg" regime has been mentioned frequently as an initial option for China to consider as an alternative to its fixed peg to the U.S. dollar.

Given China's rapid emergence as an international trading powerhouse, it is instructive to view China alongside the United States' other major trading partners, rather than by the currency-regime type. See Table 3 and Chart 3. As shown, China has quickly become the United States' fourth largest trading partner in terms of overall trade volume (and third largest among individual countries). Moreover, having now overtaken both Japan and Mexico, China trails only Canada among individual nations exporting to the United States. Clearly, Chart 3 shows that China's volume of trade is much more consistent with the United States' major trading partners, which stands in stark contrast to China's corresponding comparability with other fixed-peg countries, as shown in Charts 1 and 2. Nevertheless, among the United States' major trading partners, China stands alone as the only one without a floating regime vis-à-vis the U.S. dollar.[8]

Finally, Chart 4 illustrates the issues from the broadest perspective. The chart shows the full range of currency regimes along the bottom axis, organized according to their typical classification and degree of restrictiveness. For each regime type, selected countries are shown, providing an overview of which countries are using each regime. The placement of each country along the vertical axis is dependent upon its volume of trade with the United States.

The graph clearly illustrates the point that below a certain level of total trade with the United States (i.e., U.S. $30 billion), there is considerable diversity in the currency regimes employed by U.S. trade partners, with each regime well-represented except monetary unions. The corollary point is that above U.S. $50 billion in total trade with the United States, floating

[8] As discussed earlier, although the European Union's regime is classified as a hard peg, the euro floats freely against the dollar, so from the perspective of the United States, the EU's regime effectively acts as a true floating regime. In contrast, the yuan has remained effectively fixed against the U.S. dollar since the revaluation on July 21, 2005.

regimes become far more dominant among the trading partners. Again, the sole exceptions are the European Union, which, as noted previously, employs a monetary union that otherwise freely floats against the U.S. dollar, and China, which holds firm to its effective-pegging arrangement alongside comparatively minor economies and trading partners.

2. Recent Trends in Relative Use of Exchange-Regime Types

Since 1990, there has been an unmistakable shift away from intermediate regimes, especially among developed countries, but also within the group of emerging-market countries in which China is classified. Most of the shift has been toward floating regimes (especially among emerging-market countries) and, to a lesser extent, hard pegs (driven almost entirely by the EMU). See Table 4 and Charts 5A through 5C.

Among developed countries, which include the United States and most of its major trading partners except China and Mexico, the use of intermediate regimes disappeared completely during the 1990-2001 timeframe. As shown in Chart 5A, the majority of the shift away from intermediate regimes was toward hard pegs, due entirely to the implementation of the EMU in the time period, although the employment of floating regimes still increased significantly among developed countries.

Among emerging-market countries, which include China, Mexico, Korea and Brazil, the employment of intermediate regimes has fallen dramatically. While more than 80 percent of the emerging-market countries employed intermediate regimes in 1995, the proportion dropped to just 34 percent by 2001. As shown in Chart 5B, most of the shift was toward floating regimes, although the use of hard pegs also increased steadily over the period.

Among all member countries, the trend is even clearer – a steady shift away from intermediate regimes and toward floating regimes. Employment of hard pegs increased notably in 2001, due to the implementation of the EMU, but otherwise has remained stable. While the

implications of Chart 5C are clear in terms of highlighting trends in the IMF members' thinking and, more importantly, their actions about exchange-rate regimes, the chart still understates the case.

The IMF membership in the period reviewed comprised more than 180 countries, which include all of the United States' major trading partners. As discussed in the previous section on the country composition of each regime type, however, there are a large number of very small countries employing intermediate regimes. Consequently, analyses of overall data on IMF membership often give the misimpression of widespread use of intermediate regimes. According to Chart 5C, even after the steady decline over the period, intermediate regimes appear to remain the most widely employed among all IMF members. It is important to keep in mind, however, that this apparent measure of "popularity" is simply the percentage of all countries that use those regimes, with each country weighted equally. In other words, the United States' use of a floating regime is given equal weight with, for example, Bhutan's use of a fixed-peg regime. If the charts were weighted instead by trade volume, the use of intermediate regimes would be far less significant on a percentage basis.

The foregoing makes clear that there has been a broad and continuing trend away from intermediate regimes toward floating regimes. As discussed, while there was a limited movement toward hard pegs in the period analyzed, that shift was driven essentially by the European Union's achievement of its long-standing goal of forming a common economic area and monetary union. Nearly all other exits from intermediate regimes have been toward floating regimes. The driving force behind this trend can be linked rather strongly to the fact that intermediate regimes have been implicated or involved in nearly every major currency crisis in the last decade. Whether intermediate regimes cause crises, or are even necessarily prone to

crises vis-à-vis other regimes is as controversial an issue as the selection of an appropriate regime in the first place. Once again, rather than engage in an indeterminate theoretical debate, it is helpful to look at the indisputable facts instead.

First, no floating regimes have been implicated or involved in any of the crises. Second, while it can be said that conventional fixed-peg regimes were not directly involved in any of the crises, it is important to keep in mind the previous point that the countries using this regime are generally quite small, with negligible ability even to cause a full-fledged crisis.[9] Nevertheless, it is noteworthy that Thailand, a relatively small economy that formerly employed a basket peg, is widely believed to have precipitated the Asian crisis in 1997. Finally, none of the countries that experienced a crisis maintained or exited to an intermediate regime after the crisis, with the sole exception of Malaysia.

Consequently, the countries employing intermediate regimes at the current time are dominated by the following countries, in declining order of importance:

(1) China, whose balance-of-payments imbalances and related distortions are already manifest;

(2) Malaysia, which previously proved vulnerable to contagion in the Asian crisis; and;

(3) Saudi Arabia, whose economy is exceedingly dependent on energy prices and subject to tight government controls.

Clearly, hard pegs have not been immune from problems and pressures, but their recent track record is certainly stronger than that for intermediate regimes. Moreover, while floating

[9] Some economists argue that the 1994 unification and realignment of exchange rates by China changed the terms of trade within Asia and were one of the factors, and perhaps the principal factor, contributing to the Asian financial crisis in the latter 1990s.

regimes have been subject to unacceptable or objectionable bouts of volatility at times, they have not led to any full-fledged crises. Once again, the most defensible position likely is an agnostic one – i.e., none of the regimes by itself caused or prevented a crisis. Instead, the position that seems least disputable is that, by their very nature, intermediate regimes tend to require far more governmental intervention than the other regime groups. Thus, the intermediate regimes' apparent vulnerabilities most likely stem from the misguided actions of the governmental authorities who act too soon or too late, too frequently or infrequently, excessively or inappropriately, etc. Simply put, the intermediate regimes tend to suffer from the dual weakness of giving relatively wide latitude to governmental discretion at the same time they require the exercise of such discretion in order to function properly.

As discussed next, China's checkered history of intervention and manipulation of its foreign currency markets do not bode well against this backdrop. From a structural standpoint, China stands alone in its continued use of intermediate regimes given its size and integration into the global economy. Meanwhile, its employment of an intermediate regime requires the government's active command and control of the exchange markets in order to manage the competing pressures of supply and demand that would otherwise yield a different price result than the one the government wants. In effect, China purports to shield its vulnerable financial markets until they can develop enough to withstand the rigors of more open-market competition. The question that remains is whether the Chinese government's shield is promoting or thwarting that development, and whether, in the case of the former, the government can keep all the balls in the air while the rest of the world waits.

D. China's Foreign-Exchange Regime

1. Introduction

While China has modified its foreign-exchange system in certain respects over the last 25 years, and particularly in the last 12 years, its system with limited exceptions has been and very much still is characterized by significant and wide-ranging (if not complete) control, intervention and manipulation by the central government, as well as a nearly complete absence of market-driven forces and disciplines. Even after 25 years of adjustments by China, significant structural imbalances and distortions remain firmly embedded in the market and show few signs of abating.

Historically, China has borne much of the brunt of the inefficiencies and volatility that stemmed from such pervasive and often misguided governmental involvement in its economy and markets. The more extensive foreign-exchange amendments that were undertaken by China beginning in 1994, while marginally reducing the distortions produced by the system, have been far more effective in shifting those burdens beyond China's borders. As China's trade and integration with the global economy have accelerated in the last five years, the migration of those burdens likewise has accelerated. With the yuan effectively pegged to the U.S. dollar, the United States has been a primary casualty of this transfer. China either must undertake the reforms needed to significantly reduce these burdens overall, or the United States will have to take measures to force China to bear more of the burdens China has created and refuses to meaningfully address.

2. Historical Perspective

Even a cursory and limited review of the development of China's foreign-exchange system prior to 1994 is a complex and expansive undertaking given the nearly complete degree of control exercised over the system by China's central government and monetary authorities. The extent and persistence of this intervention produced a seemingly endless cycle of distortions

and imbalances, followed by continuous policy shifts marked by alternating phases of restrictiveness and modest liberalization. Rather than recount these myriad developments in detail, the summary provided below is intended to highlight the fundamental characteristics of China's pre-1994 system and the government's general policy objectives, most of which continue to the present.[10]

- Intentional and persistent currency misvaluation, whether overvaluation of the yuan to subsidize imports of capital goods or undervaluation of the yuan to slow rapid import growth and/or promote export growth.
- Strict and direct control over the price (value) of foreign exchange as well as the supply and demand of foreign exchange.
- Significant divergences between the controlled official exchange-rates of the yuan and more market-based rates, whether legal (i.e., authorized swap or settlement markets) or illegal (i.e., black market).
- The divergences between official exchange-rates of the yuan and less-controlled rates repeatedly spawned a host of supply/demand imbalances and other distortions that the Chinese government either attempted to regulate out of existence or absorb on its own, rather than address their root causes.

Taken in their entirety, China's command and control of the exchange market and of the broader economic and financial system can be described as haphazard, biased, inadequate,

[10] See Guijun, Lin and Ronald M. Schramm. May 2003. "China's Foreign Exchange Policies Since 1979: A Review of Developments and an Assessment." University of International Business and Economics, Beijing. Shen, Jian-Guang. Undated. "China's Exchange-rate System after WTO Accession: Some Considerations." Bank of Finland, Institute for Economies in Transition. Waldman, Cliff. February 11, 2004. "The Battle Over the Yuan: The Perspective of China's Self Interest." Manufacturers Alliance/MAPI Economic Report.

excessive, and unwarranted. With prices, supply and demand so tightly controlled throughout the economy, it is not surprising that the Chinese government's policy and regulatory actions with respect to foreign exchange prior to 1994 consistently produced unintended consequences. In the final analysis, China's continuing intervention prevented any sustainable equilibrium from developing. Consequently, the economic and financial system often exhibited tremendous volatility, notwithstanding the Chinese government's stated goal of promoting stability as justification for its interference.

3. Current Perspective

In 1994, China made a major effort to address the persistent problems and imbalances in its foreign-exchange system. Three major changes were implemented.

(1) The swap market was abolished and replaced by a national market.[11]

(2) The dual-rate system was abolished, and the official and former swap rates were unified at an initial level of 8.70 yuan/U.S. dollar.

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[11] In 1981, the official controlled exchange-rate of 1.54 yuan/U.S. dollar appeared significantly overvalued and was causing China's export sector to be deeply unprofitable. Rather than continue to directly subsidize the export sector's losses, the Chinese government decided to implement a dual-rate regime by adding a secondary rate (known as the Internal Settlement Rate or "ISR"). This rate was substantially devalued vis-à-vis the prevailing official rate (2.80 yuan/U.S. dollar) and was restricted to use in foreign trade-related transactions only.

In 1984, China abolished the ISR in response to pressure by the IMF and other criticism of the dual-rate system. At this time, China reinstated direct subsidies to the export sector to offset its exchange-related losses. The government also relaxed its foreign-exchange retention scheme, which permitted exporters to retain a portion of their foreign-exchange earnings that previously were required to be surrendered in full to China's state-owned banks. With exporters permitted to hold foreign currency within the domestic economy, a swap market developed to facilitate currency exchanges for exporters (as well as foreign firms operating in China that were exempt from the surrender requirements in the first place). As the swap market developed, its exchange-rate diverged from the official rate, leading to the reemergence of a dual-rate system. Both the swap market and the dual-rate system were abolished in the 1994 reforms.

(3) The foreign-exchange retention scheme was abolished, and domestic enterprises were once again required to surrender all of their export earnings to the Chinese government via designated foreign-exchange banks. Purchases of foreign exchange remained subject to prior approval and settlement at the prevailing "market rate" effectively set by the central bank.[12]

These reforms have had very significant implications for China going forward and set the stage for much of its current market structure. By unifying the official and swap-market rates under a single interbank rate, the Chinese government took a potentially important step toward actually implementing a true, "managed-float" regime that it had notified the IMF was in place some seven years earlier in 1987.

In practice, however, the interbank market never floated to any significant degree and remained dominated by the government.[13] In the 15 years prior to the 1994 reforms, China engaged in ongoing battles with market forces over the exchange value of the yuan. In an effort to prevent these divergences from appearing again in the new interbank market, the government imposed very narrow bands (± 0.3 percent) on the reference exchange-rate published by the central banking authority (i.e., the State Administration of Foreign Exchange or "SAFE").

The very limited degree of exchange-rate fluctuations in the interbank market hampered its development. With the interbank rate unable to adjust adequately to market conditions, the Chinese government dominated the market, accounting for 70 percent of the total sales of foreign

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[12] Since 1994, the Chinese government has amended the foreign-exchange surrender and retention requirements by changing their applicable rates and limits, as well as the extent to which domestic and foreign enterprises are subject to such requirements.

[13] The Chinese government exerted control over the foreign-exchange market through two state-controlled banks – the Bank of China ("BOC") and the People's Bank of China ("PBC"). In the 1979 reforms, the government established the State Administration of Foreign Exchange ("SAFE") as part of the BOC and assigned it a primary role in the market. In 1982, SAFE was transferred to the control of the PBC, which subsequently assumed a primary role in the foreign-exchange market.

exchange and 60 to 70 percent of the total purchases of foreign exchange. The government's continuing dominant role was necessitated by its refusal to allow the interbank exchange-rate to adjust adequately, as well as its tight controls over foreign-exchange holdings in the domestic economy, which were still mandatorily required, in large part, to be surrendered to the state-owned banks. In addition, the state-designated foreign-exchange banks were subject to strict quotas that limited their holdings of foreign exchange. Beyond these quotas, foreign exchange had to be surrendered to SAFE. The resulting imbalances in the market, in the form of excess supply of foreign exchange, forced the PBC (via SAFE) to step in as the market's primary buyer, setting the stage for a long upward climb in China's foreign reserve holdings.

Within two years by 1996, China's reserves had tripled from U.S. $26 billion to U.S. $78 billion. Despite the government's continuing intervention against the yuan in the market, the interbank rate still managed to appreciate from its initial level of 8.70 yuan/U.S. dollar in January 1994 to approximately 8.30 yuan/U.S. dollar at the end of 1995. From that point in time forward, including since the modest revaluation of 2.1 percent of the yuan on July 21, 2005, China effectively fixed the exchange-rate as it remains today. By April 1999, as commented earlier, the IMF formally recognized that China's foreign-exchange regime was not, in fact, a managed float as China had reported, and reclassified it as a conventional pegged arrangement.

4. The Mechanics of China's Effectively Pegged Regime

China's effectively pegged regime requires an expansive role in the market by the government, because it alone is in a position to manage the resulting supply and demand imbalances that stem from China's decision to maintain the fixed price of the yuan. From a broad perspective, therefore, the Chinese government must be prepared to exercise two basic policy options, as follows:

(1) Supply-side controls: to keep the exchange rate from appreciating, the government must purchase any excess supply of foreign exchange; alternately, or in addition, the government can attempt to reduce an excess supply of foreign exchange (or increase the demand for foreign exchange) through regulation.

(2) Demand-side controls: to keep the exchange rate from depreciating, the government must sell foreign exchange to meet any excess demand; alternately, or in addition, the government can attempt to reduce an excess demand for foreign exchange (or increase the supply of foreign exchange) through regulation.

a. Supply-Side Controls

The primary authorized components of China's foreign-exchange supply are limited to foreign-exchange export revenues, the repatriation of profits earned by Chinese firms abroad, and foreign direct investment inflows. For the most part, two other typically important sources -- borrowing abroad and foreign portfolio investment (e.g., purchases of Chinese bonds and securities by foreigners) -- are strictly limited if not prohibited by the government and are, therefore, not significant factors in the Chinese economy.

As Chinese exports and foreign direct investment inflows increase, as they have since 1994 (and particularly since the Asian currency crisis), China's supply of foreign exchange likewise has increased. Given the Chinese government's goal of promoting exports and inward investment, it does not want to discourage that supply. In the absence of a market-clearing price mechanism due to the fixed exchange-rate, the government is forced either to permit more demand for foreign exchange within its economy (which runs counter to its efforts to control the value of the yuan) or to create that demand by virtue of its own intervention in the market as the primary buyer of foreign exchange.

China has tended to favor the latter strategy, which does not conflict with the government's application and maintenance of strict controls. Consequently, the rapid increase in foreign-exchange export revenues and foreign direct investment inflows in the face of continuing strict controls on foreign-exchange holdings has forced the government to purchase ever-increasing surpluses of foreign exchange. While this strategy may have the advantage of maintaining a certain control for the government, this approach is conducive to risks and severe distortions. When the Chinese government purchases foreign exchange, it does so by printing money and increasing the supply of yuan in the domestic economy, while its holdings of foreign exchange reserves increase. Rapid and sustained increases in the money supply, however, tend to promote excessive domestic demand and investment, which have occurred in recent years. These developments, in turn, lead to the inefficient allocation of resources and increased inflationary pressures throughout China's economy.

As has been the historical pattern, the government's interference with market disciplines first causes problems; subsequent measures merely shift the incidence of the problems or defer their impact. Normally, an overheating economy and inflationary pressures would put upward pressure on interest rates, which, if permitted to rise, would tend to slow the domestic economy and induce some of the excess money supply to flow out of the country. Interest rates (and credit), however, are government-controlled and unresponsive to market forces, while capital outflows are similarly constrained. The Chinese government accordingly must resort to a host of weaker, secondary measures that attempt to offset the distortions and imbalances caused by its intervention. In general, these secondary measures are all limited in effect or duration and often are counter to other policy goals of the government.

(1) The central bank has conducted increasingly extensive open-market operations to "sterilize" the increase in the supply of yuan – the government can temporarily reduce the growth in the money supply by selling debt into (i.e., borrowing from) the domestic economy. In essence, the government trades governmental debt securities for the excess supply of yuan it previously created in its foreign-exchange operations. While sterilization effectively removes yuan from the economy, it causes other adverse effects by putting upward pressure on interest rates, "crowding out" other borrowers and increasing fiscal pressure on the government. In addition, because the borrowings will eventually mature or be repaid, the effects on the money supply are only temporary.

(2) The Chinese government has allowed a greater volume of foreign exchange to be held within the domestic economy (in lieu of forcing total conversions to yuan) by relaxing surrender requirements and permitting domestic firms to maintain limited foreign-exchange accounts. While this liberalization tended to undermine its control over the foreign-exchange market, the government appears more willing to take that risk as ever-building pressures begin to dilute the impact of its more direct policy options.

(3) China has reduced the supply of yuan by directly withdrawing loans and lending credits previously made to support the banking sector or finance special projects. In addition, in an effort to restrain lending growth, the government recently increased banking reserve requirements, which effectively force the banking sector to hold more yuan, thereby reducing the supply of yuan in the domestic economy.

In summary, China's supply-side controls work first by limiting foreign-exchange holdings in the economy and then by the government's absorption of the foreign-exchange surpluses that these controls create. In effect, the Chinese government's policies have

transformed the "market" into a crab pot of sorts, allowing foreign exchange to flow freely into the country, but severely restricting its flow in and back out of the country. Foreign exchange thus amasses as increased reserve holdings, which effectively represent deferred or future demand for yuan. When seen from this perspective, it is clear that China maintains a conscious policy goal of artificially shifting current demand for yuan into the future in order to prevent the yuan from appreciating now, as market forces would dictate.

The Chinese government's supply-side manipulations, therefore, are most directly evident in its surging foreign-exchange reserve holdings. The rapid increase and level of these reserves clearly suggest that China's balance-of-payments is otherwise increasingly imbalanced and that more and more demand for yuan is being deferred into the future.

b. Demand-Side Controls

The Chinese government likewise has employed an array of measures designed to sharply restrict and control the demand for foreign exchange. In order to maintain control over the price or value of the yuan, China must maintain very strict controls over foreign-exchange holdings (i.e., demand) within the Chinese economy, because increased holdings of foreign exchange complicate China's efforts to control the price of the yuan. Given the strict controls or outright prohibitions on capital outflows, the demand for foreign exchange within the Chinese economy is limited principally to purchasing imports and making payments on foreign debt.

On December 1, 1996, China accepted the obligations of Article VIII of the IMF's Articles of Agreement. As a result, China substantially liberalized current account convertibility covering payment for goods and services, as well as the repatriation of profits from foreign companies operating in China. While this action was a significant improvement from China's previous policies, restrictive elements remain. For instance, foreign companies are still required to surrender their foreign-exchange earnings above certain limits, while domestic firms remain

barred from retaining their foreign-exchange earnings altogether, with the exception of a partial exemption for several large, state-owned enterprises. Purchases of foreign exchange by private individuals and households remain subject to restrictions.

Ironically, the maintenance of strict controls on capital-account transactions, at the same time current-account transactions were liberalized, has forced China to subject current-account transactions to new regulations and closer scrutiny in order to prevent unauthorized capital outflows through the current account.

China maintains a labyrinthian array of restrictions on capital-account transactions and has generally confined its liberalization to facilitating inflows of foreign direct investment. Nearly every other aspect of operations in China's capital account is subject to advance approval, licensing or certification, explicit limits, conditional requirements or outright prohibitions. A summary of these controls is contained in Attachment 2.

China has attempted to justify these restrictions on a number of grounds, but none is consistent with China's commitments to the World Trade Organization ("WTO"). Paradoxically, China's two primary justifications for maintaining the strict controls on the capital account are (1) fear of rapid and destabilizing capital inflows and (2) fear of rapid and destabilizing capital outflows.

With regard to inflows, China fears that liberalization could lead to significant capital inflows from foreign investors seeking to speculate in its financial markets, particularly as to a higher revaluation of the yuan. Moreover, that influx of portfolio investment and liquidity from foreigners into the financial system might induce Chinese banks to increase their lending or lend less prudently and further destabilize the already weak banking sector.

With regard to outflows, China fears that liberalization could lead to wholesale capital flight by Chinese savers and investors seeking either to diversify their holdings or reduce their exposure to credit risks in the weak Chinese financial system. Rapid and substantial withdrawals from the banking system would not only put downward pressure on the value of the yuan, but also would cause a potential liquidity crisis or collapse in the banking sector.

In summary, China's demand-side controls essentially are preemptive in nature by limiting the opportunities of its citizens and companies to need, use or invest foreign exchange. Despite achieving current-account convertibility, China retains direct ceilings on permitted foreign-exchange holdings, as well as an array of indirect measures used to verify, link and otherwise control foreign-exchange holdings. While China justifies these measures as a necessary shield for its underdeveloped internal financial system, there seems little doubt that these measures have contributed to the vulnerability of the system and potentially pose its greatest threat. As the evidence has shown, the Chinese government's long and extensive history of intervention has yielded few apparent benefits; rather, governmental policies have been characterized by the creation of distortions that subsequently are redressed through further-distorting measures. Ultimately, this perilous circle can achieve little of permanence except a misallocation of resources.

5. Balance-of-Payments Implications

a. Generalized Distortions

China's capital controls constitute strong and expansive policy tools that are indispensable to the Chinese government's ability to suppress market forces and keep the exchange rate effectively fixed in the face of a significant excess supply of U.S. dollars (or excess demand for yuan). Moreover, these controls reflect merely another instance of one

distortion (an effectively fixed and undervalued exchange rate) begetting another (capital controls) in China's increasingly paradoxical battle against market forces.

Moreover, as the Chinese government has liberalized current-account transactions, it has had to become even more vigilant in controlling not only the capital account, but also capital flows being disguised through the current account. Thus, besides being partial, China's liberalization efforts frequently tend to produce administrative difficulties that significantly undermine their limited benefits in the first place.

As shown in the matrix in Attachment 2 and discussed earlier, the Chinese government's interference in capital-account transactions is so extensive that there is a fundamental uncertainty in the market whether substantial capital inflows or substantial capital outflows would result if normal market forces were permitted rather than systematically thwarted by China. In fact, China has so subjugated normal market forces that equilibrium and future values are all but unknown to investors and borrowers, who instead are guided, quite logically in the short-run, by the time-proven expectation of a continuation of the status quo. Thus, the market operates in a vacuum created and controlled by the Chinese government, undeterred by the growing imbalances and pressures that clearly point to a different outcome, but for the government's interference.

b. Exchange-Rate Effects

When the United States' balance-of-payments position is discussed, it often is noted that the large current-account deficit must, by definition, be offset by a comparable capital-account surplus (assuming official reserves remain unchanged). Underlying this principle is the national-account identity stating that if the United States *spends* (i.e., consumption plus investment) more than it *earns* (i.e., consumption plus savings), the excess spending is equal to the current-account

deficit. The current-account deficit, in turn, can also be expressed as a function of the excess of U.S. imports over U.S. exports.

As a result of the current-account deficit, therefore, the United States must borrow funds to pay for its excessive investment (i.e., its spending is too high) or to offset its inadequate savings (i.e., its earnings are too low). This borrowing constitutes a capital-account inflow, which leads to an overall capital-account surplus that offsets the corresponding current-account deficit.

The United States' balance-of-payments is considered to be in balance because the current-account deficit is, in fact, offset by the capital-account surplus. From a currency perspective, the current-account deficit produces an excess supply of U.S. dollars (from U.S. purchasers) that would, by itself, tend to cause the value of the U.S. dollar to decrease. The capital-account surplus, however, produces an offsetting excess demand for U.S. dollars (from foreign lenders seeking to lend in the United States). When the current-account deficit is balanced by the capital-account surplus, the excess demand for U.S. dollars (by foreign lenders) is met by the excess supply of U.S. dollars (from U.S. purchasers), thereby mitigating any pressure on the value of the U.S. dollar to either appreciate or depreciate.

In China's case, however, both its current and capital accounts are significantly in surplus. This means that China not only *earns* (i.e. consumption plus savings) more than it *spends* (i.e., consumption plus investment), but also is a net borrower rather than a net lender to the rest of the world.[14] This situation is due to China's capital-outflow controls, which sharply

[14] Given its current-account surplus, China typically would be expected to be a net lender in its capital account.

limit and reduce the opportunities for Chinese entities to lend or invest abroad.[15] With its current and capital accounts both in surplus (rather than in offsetting balance), China's foreign-exchange reserves must increase by the amount of the combined surpluses in the current and capital accounts.

From a currency perspective, the current-account surplus means that China exports more than it imports, which in turn means that China earns more foreign exchange through its exports than it spends on its imports (i.e., excess foreign exchange). Similarly, the capital-account surplus means that China is receiving more foreign investment than it is making in foreign markets, which in turn means that China has a net surplus of foreign exchange in its capital account as well.

With the surplus of foreign currency flowing into China at the same time that direct uses of the foreign currency remain blocked or limited, an excess demand for yuan develops as Chinese individuals and businesses seek to convert the foreign exchange into yuan for employment and use in the domestic economy. Thus, as the supply of foreign exchange in China increases, so does the corresponding demand for yuan.

The persistent and significant imbalance in favor of the demand for yuan over the supply of foreign currency normally would bid up the value of the yuan vis-à-vis the foreign currency. Instead, China restrains the value of the yuan from rising by unilaterally increasing the supply of yuan, which is accomplished merely by printing more currency. Rather than allow market forces to decrease the value of the foreign currency and increase the value of the yuan, the Chinese government steps in, using its monetary authority as a virtually rigid price support for the foreign

[15] Meanwhile, foreign-direct investments into China are freely permitted. Thus, in trade terms, China's capital-account controls are similar in their balance-of-payments effects as import barriers and restrictions.

currency. In effect, the government signals to the market that it stands prepared to purchase any amount of foreign currency necessary to clear the market at its fixed, artificially-supported and desired price.

When seen from this perspective, it becomes clearer that China's burgeoning foreign-exchange reserves in effect reflect deferred demand for yuan. Rather than allow the market to express its demand for yuan now (thus bidding up the value of the yuan now), the Chinese government resorts to printing new yuan to satisfy the current demand, while it instead holds the corresponding foreign currency in reserve in order to keep it off the market. Thus, the stock of foreign-exchange reserves reflects future demand for yuan. Moreover, as the stock of reserves increases, so does the future demand for yuan and, presumably, the future value of the yuan vis-à-vis its current, artificially-suppressed value.

Source: IMF, *Exchange Arrangements and Foreign Exchange Markets: Developments and Issues, World Economic and Financial Surveys*, 2003 at 25-26.

Exhibit 1

Source: IMF, *Exchange Arrangements and Foreign Exchange Markets: Developments and Issues, World Economic and Financial Surveys*, 2003 at 25-26.

Appendix 2.1

Table 2.A1. Exchange Rate Regimes and Anchors of Monetary Policy

(As of December 31, 2001)

Exchange Rate Regime (Number of countries)	Monetary Policy Framework							
	Exchange rate anchor[1, 2]				Monetary aggregate target	Inflation targeting framework	IMF-supported or other monetary program	Other
			CFA franc zone					
Exchange arrangements with no separate legal tender (40)	**Another currency as legal tender** Ecuador† El Salvador[6] Kiribati Marshall Islands Micronesia Palau Panama San Marino	**Eastern Caribbean Currency Union[3]** Antigua and Barbuda Dominica Grenada St. Kitts and Nevis St. Lucia St. Vincent and the Grenadines	**WAEMU** Benin† Burkina Faso† Côte d'Ivoire† Guinea-Bissau† Mali† Niger† Senegal† Togo	**CAEMC** Cameroon† Central African Rep.† Chad† Congo, Rep. of† Equatorial Guinea† Gabon†				**Euro area[4, 5]** Austria Belgium Finland France Germany Greece Ireland Italy Luxembourg Netherlands Portugal Spain
Currency board arrangements (8)	Argentina† Bosnia and Herzegovina† Brunei Darussalam Bulgaria† China: Hong Kong SAR Djibouti† Estonia† Lithuania†							
Other conventional fixed peg arrangements (including de facto peg arrangements under managed floating) (41)	**Against a single currency (30)** Aruba Bahamas, The[7] Bahrain Bangladesh Barbados Belize Bhutan Cape Verde China, People's Rep. of*[8] Comoros[9] Eritrea Iran[7, 8] Jordan†[8] Lebanon[8] Lesotho† Macedonia, FYR†[8] Malaysia Maldives[8] Namibia Nepal Netherlands Antilles Oman Qatar[8, 10] Saudi Arabia[8, 10] Sudan[8] Suriname[7, 8] Swaziland Syrian Arab Republic[7] Turkmenistan[8] United Arab Emirates[8, 10] Zimbabwe[8]		**Against a composite (10)** Botswana[7] Fiji Kuwait Latvia Libyan Arab Jamahiriya Malta Morocco Samoa Seychelles Vanuatu		China, People's Rep. of*[8]			
Pegged exchange rates within horizontal bands (5)[11]	**Within a cooperative arrangement ERM II (1)** Denmark		**Other band arrangements (4)** Cyprus Egypt[7] Hungary* Tonga			Hungary*		

Table 2.A1 *(concluded)*

Exchange Rate Regime (Number of countries)	Monetary Policy Framework					
	Exchange rate anchor[1, 2]		Monetary aggregate target	Inflation targeting framework	IMF-supported or other monetary program	Other
Crawling pegs (4)	Bolivia† Costa Rica[8] Nicaragua† Solomon Islands[8]					
Exchange rates within crawling bands (6)[12]	Belarus Honduras† Israel*	Romania†[8] Uruguay† Venezuela, Rep. Bolivariana de		Israel*		
Managed floating with no predetermined path for exchange rate (42)			Ghana† Guinea† Guyana† Indonesia† Jamaica†[8] Mauritius Mongolia† São Tomé and Príncipe† Slovenia Sri Lanka† Tunisia	Thailand	Azerbaijan Cambodia[7] Croatia Ethiopia Iraq Kazakhstan Kenya Kyrgyz Rep. Lao PDR[7] Mauritania Nigeria Pakistan Russian Fed. Rwanda Trinidad and Tobago Ukraine Vietnam Yugoslavia Zambia	Algeria[4] Angola[4] Burundi[4] Dominican Rep.[4, 7] Guatemala[4] India[4] Myanmar[4, 7, 8] Paraguay[4] Singapore[4] Slovak Rep.[4] Uzbekistan[4, 7]
Independently floating (40)			Gambia, The† Malawi† Peru† Philippines† Sierra Leone† Turkey† Yemen†	Australia Brazil† Canada Chile[7] Colombia† Czech Rep. Iceland Korea Mexico New Zealand Norway Poland South Africa Sweden United Kingdom	Albania Armenia Congo, Dem. Rep. Georgia Madagascar Moldova Mozambique Tajikistan Tanzania Uganda	Afghanistan[7, 13] Haiti[4] Japan[4] Liberia[4] Papua New Guinea[4] Somalia[7, 13] Switzerland[4] United States[4]

Sources: Various IMF staff reports, *Recent Economic Developments. International Financial Statisitics.*

[1]A country with a * indicates that the country has more than one nominal anchor that may guide monetary policy. It should be noted, however, that it would not be possible for practical purposes to infer from this table which nominal anchor plays the principal role in conducting monetary policy.

[2]A country with † indicates that the country has an IMF-supported or other monetary program.

[3]These countries have a currency board arrangement.

[4]The country has no explicitly stated nominal anchor, but rather monitors various indicators in conducting monetary policy.

[5]Until they were withdrawn in February 2002, national currencies retained their status as legal tender within their home territories.

[6]For El Salvador, the printing of new colones, the domestic currency, is prohibited. The existing stock of colones will continue to circulate along with the U.S. dollar as legal tender until all colón notes physically wear out.

[7]Member maintained exchange regimes involving more than one market. The regime shown is that maintained in the major market.

[8]The indicated country has a de facto regime, which differs from its de jure regime.

[9]Comoros has the same arrangement with the French Treasury as do the CFA Franc Zone countries.

[10]Exchange rates are determined on the basis of a fixed relationship to the SDR, within margins of up to ±7.25%. However, because of the maintenance of a relatively stable relationship with the U.S. dollar, these margins are not always observed.

[11]The band width for these countries is: Cyprus (±2.25%), Denmark (±2.25%), Egypt (±3%), Hungary (±15%), and Tonga (±5%).

[12]The band for these countries is: Belarus (±5%), Honduras (±7%), Israel (±22%), Romania (unannounced), Uruguay (±3%), and Rep. Bolivariana de Venezuela (±7.5%).

[13]There is no relevant information available for the country.

Table 1

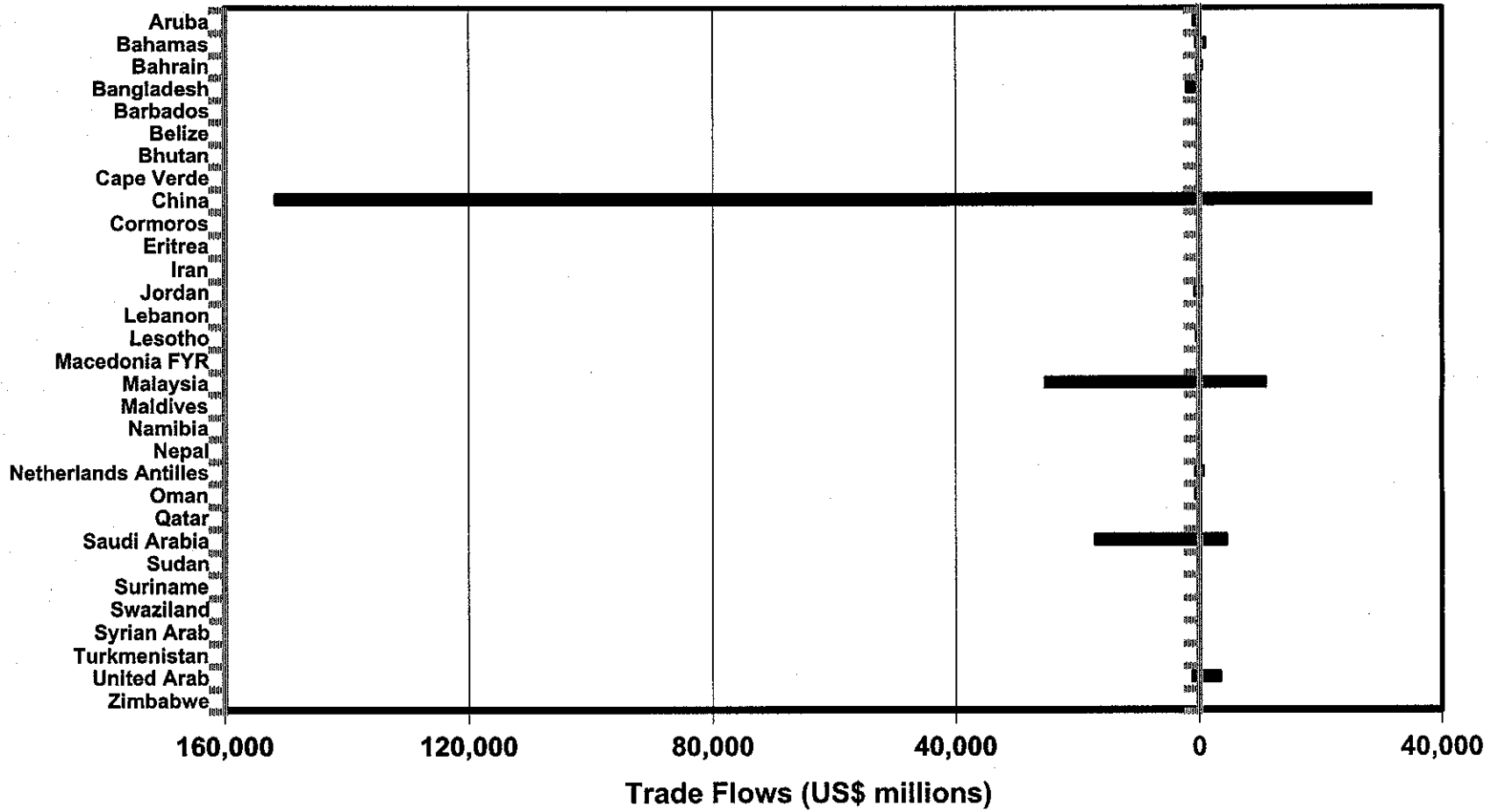
Countries Employing Conventional Fixed-Peg Currency Regimes (Single Currency)
Manufactures Trade Flows with United States, Annual 2003
(millions of US dollars)

Country	Exports to the United States	Imports from the United States	United States Trade Balance w/Partner	Total Trade with United States	Pct Share
Aruba	(842)	355	(487)	1,197	0.5%
Bahamas	(473)	1,084	611	1,557	0.6%
Bahrain	(378)	509	131	887	0.3%
Bangladesh	(2,074)	227	(1,848)	2,301	0.9%
Barbados	(43)	302	259	345	0.1%
Belize	(101)	199	98	301	0.1%
Bhutan	(1)	1	1	2	0.0%
Cape Verde	(6)	9	3	15	0.0%
China	**(151,620)**	**28,418**	**(123,202)**	**180,039**	**70.2%**
Cormoros	(4)	1	(3)	5	0.0%
Eritrea	(0)	87	87	87	0.0%
Iran	(161)	99	(62)	260	0.1%
Jordan	(673)	492	(181)	1,165	0.5%
Lebanon	(94)	314	220	408	0.2%
Lesotho	(393)	5	(388)	398	0.2%
Macedonia FYR	(62)	26	(36)	89	0.0%
Malaysia	(25,321)	10,921	(14,400)	36,241	14.1%
Maldives	(94)	7	(88)	101	0.0%
Namibia	(123)	28	(95)	151	0.1%
Nepal	(171)	16	(155)	188	0.1%
Netherlands Antilles	(632)	747	116	1,379	0.5%
Oman	(607)	323	(283)	930	0.4%
Qatar	(332)	408	77	740	0.3%
Saudi Arabia	(17,112)	4,596	(12,516)	21,708	8.5%
Sudan	(3)	26	23	29	0.0%
Suriname	(140)	193	53	333	0.1%
Swaziland	(162)	8	(154)	170	0.1%
Syrian Arab Republic	(241)	214	(27)	455	0.2%
Turkmenistan	(80)	34	(45)	114	0.0%
United Arab Emirates	(1,134)	3,510	2,376	4,645	1.8%
Zimbabwe	(67)	42	(25)	108	0.0%
Total	**(203,145)**	**53,202**	**(149,942)**	**256,347**	**100.0%**
China share of total	*75%*	*53%*	*82%*	*70%*	*70%*

SOURCE: IMF and U.S. International Trade Commission.

CHART 1

U.S. Trade Flows with Partners Employing Single-Currency-Peg Arrangments



NOTE: *See Table 1. Exports to United States are shown as negative numbers, while imports from the United States are shown as positive numbers.*

Table 2

Countries Employing Conventional Fixed-Peg Currency Regimes (Basket Currency)
Manufactures Trade Flows with United States, Annual 2003
(millions of US dollars)

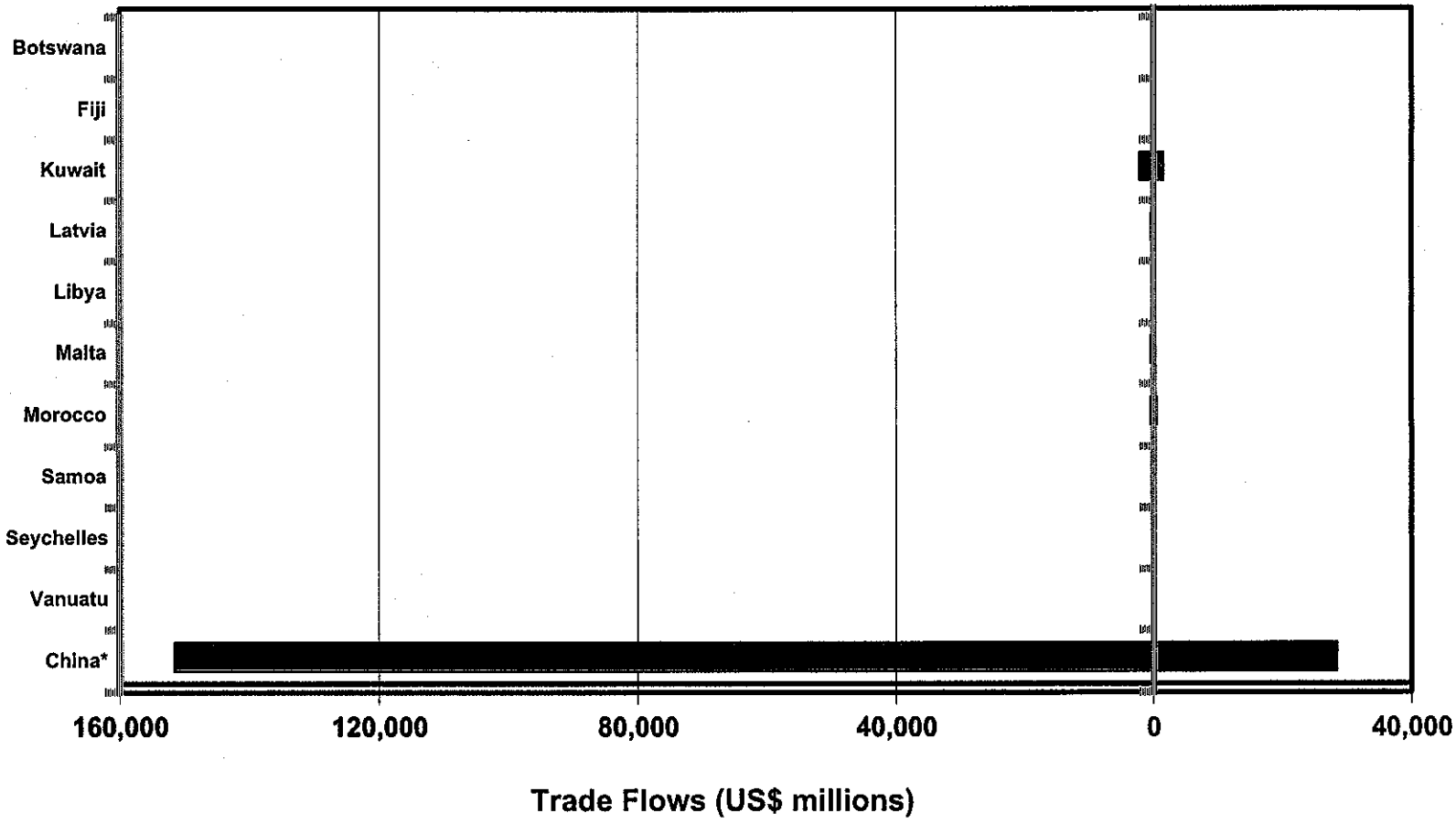
Country	Exports to the United States	Imports from the United States	United States Trade Balance	Total Trade with United States	Pct Share
Botswana	(14)	26	12	40	0.02%
Fiji	(175)	20	(156)	195	0.10%
Kuwait	(2,125)	1,509	(616)	3,634	1.95%
Latvia	(395)	124	(271)	519	0.28%
Libya	-	0	0	0	0.00%
Malta	(369)	202	(167)	570	0.31%
Morocco	(396)	465	69	861	0.46%
Samoa	(4)	11	7	16	0.01%
Seychelles	(15)	7	(8)	22	0.01%
Vanuatu	(1)	1	1	2	0.00%
China*	**(151,620)**	**28,418**	**(123,202)**	**180,039**	**96.85%**
Total	**(155,115)**	**30,784**	**(124,332)**	**185,899**	**100.00%**
China share of total	*98%*	*92%*	*99%*	*97%*	*97%*

(*) China included in this group for comparison purposes only.

SOURCE: IMF and U.S. International Trade Commission.

CHART 2

U.S. Trade Flows with Partners Employing Basket-Peg Arrangments



NOTE: ***See Table 2. Exports to United States are shown as negative numbers, while imports from the United States are shown as positive numbers. (*) China included for comparison purposes only.***

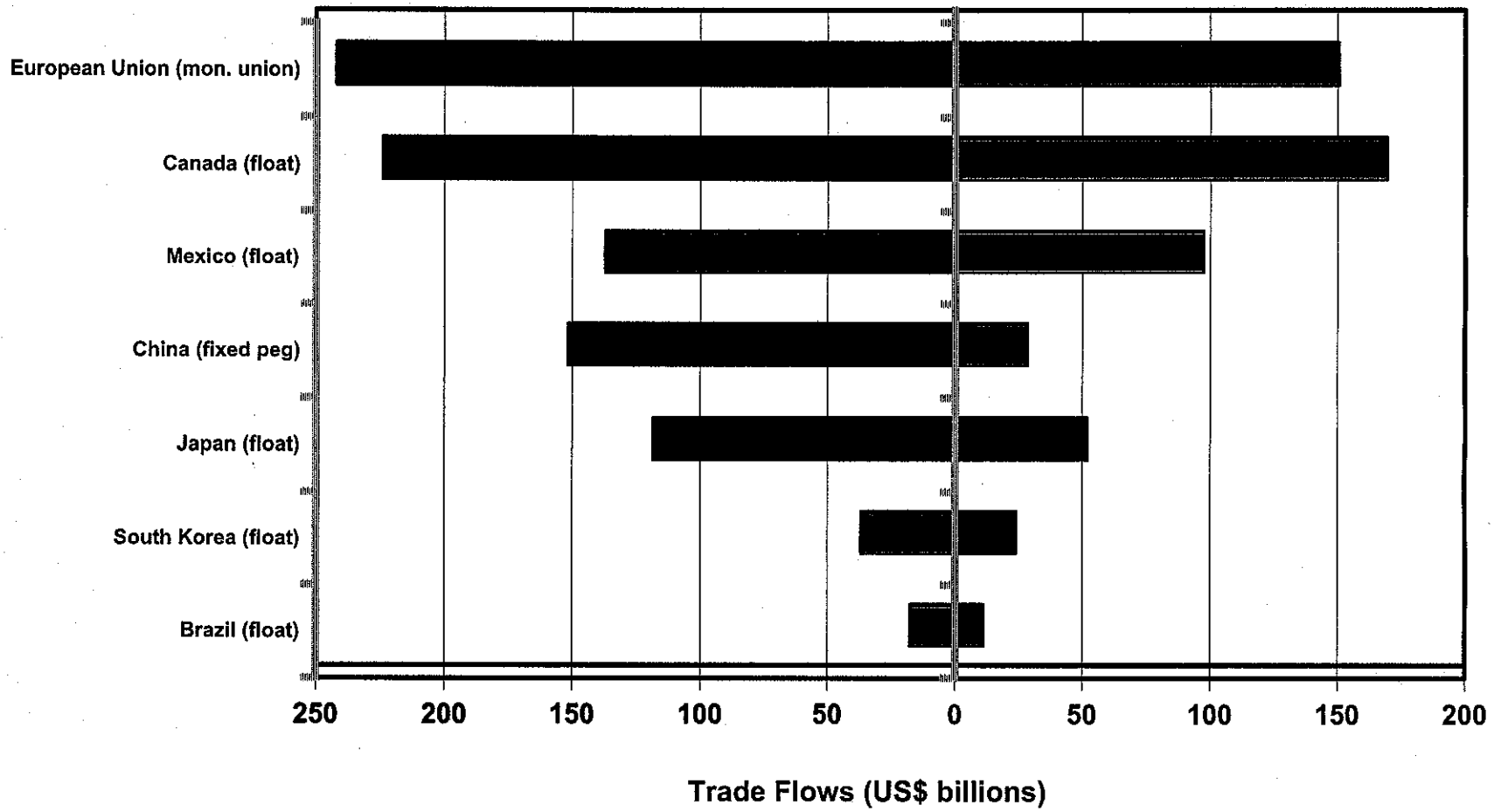
Table 3

United States' Top Trading Partners
Manufactures Trade Flows with United States, Annual 2003
(billions of US dollars)

Country (regime type)	Exports to the United States	Imports from the United States	United States Trade Balance w/Partner	Total Trade with United States	Pct Share
European Union (mon. union)	(242)	151	(92)	393	36.8%
Canada (float)	(224)	169	(55)	393	36.8%
Mexico (float)	(137)	97	(40)	235	22.0%
China (fixed peg)	**(152)**	**28**	**(123)**	**180**	**16.8%**
Japan (float)	(118)	52	(66)	171	16.0%
South Korea (float)	(37)	24	(13)	61	5.7%
Brazil (float)	(18)	11	(6)	29	2.7%
Total	**(686)**	**383**	**(303)**	**1,069**	**100.0%**
China share of total	*22%*	*7%*	*41%*	*17%*	*17%*

SOURCE: IMF and U.S. International Trade Commission.

CHART 3
U.S. Trade Flows with Top Trading Partners



NOTE: ***See Table 3. Exports to United States are shown as negative numbers, while imports from the United States are shown as positive numbers.***

CHART 4

COMPARISON OF TRADING PARTNERS' CURRENCY REGIMES WITH LEVEL OF TRADE WITH THE UNITED STATES

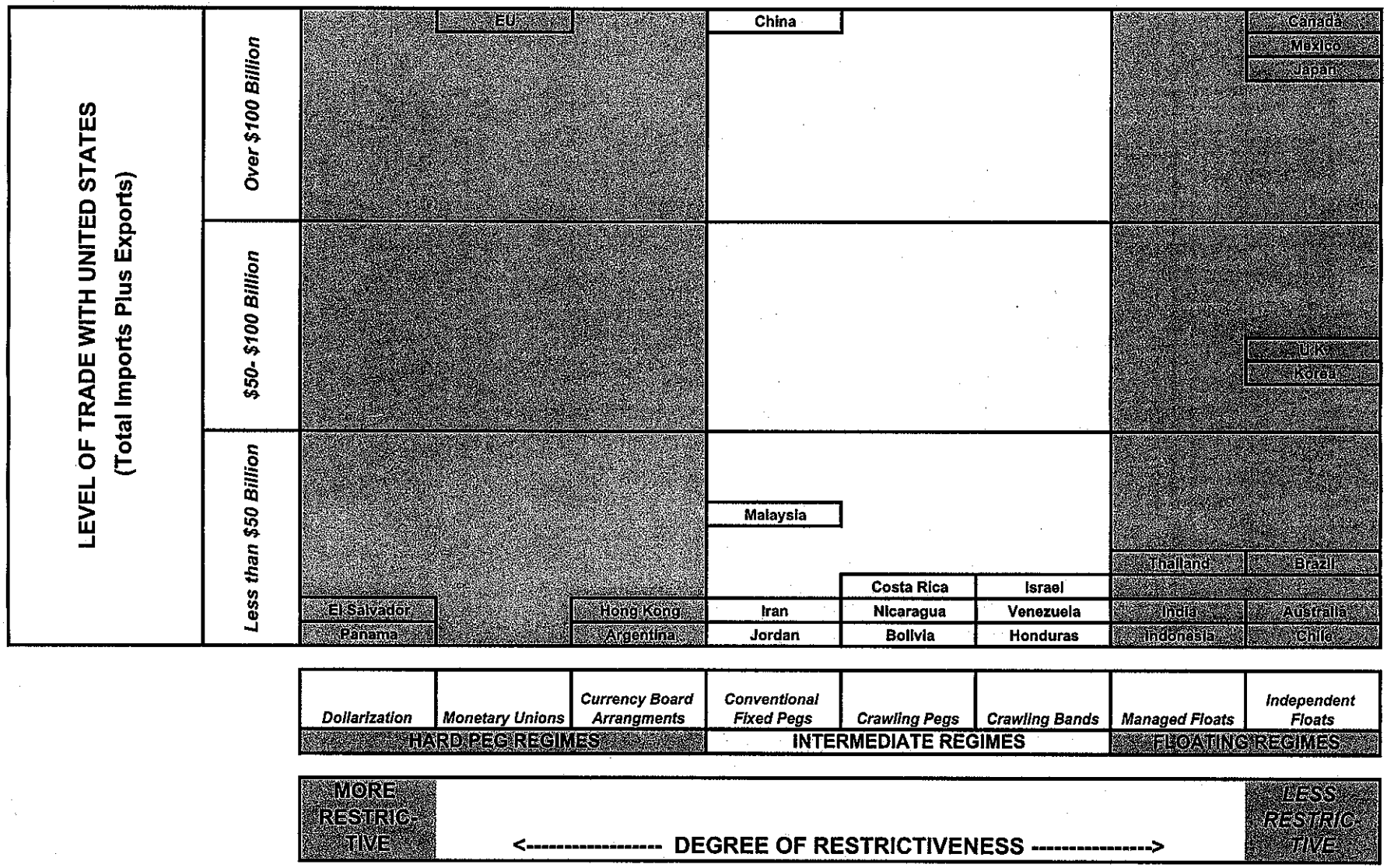


Table 4

Evolution of Exchange-Rate Regimes by Country Group
Annual Periods 1990, 1995 and 2001
(in percent of members in each category)

Country Grouping	1990	1995	2001
Developed Countries (1)			
Hard Pegs	0%	4%	54%
Intermediate Regimes	74%	54%	4%
Single currency fixed pegs	13%	13%	0%
Floating Regimes	26%	42%	42%
Emerging Market Countries (2)			
Hard Pegs	7%	9%	16%
Intermediate Regimes	77%	81%	34%
Single currency fixed pegs	13%	13%	9%
Floating Regimes	17%	9%	50%
All IMF Members			
Hard Pegs	16%	16%	26%
Intermediate Regimes	69%	59%	39%
Single currency fixed pegs	25%	22%	17%
Floating Regimes	15%	25%	36%

NOTES

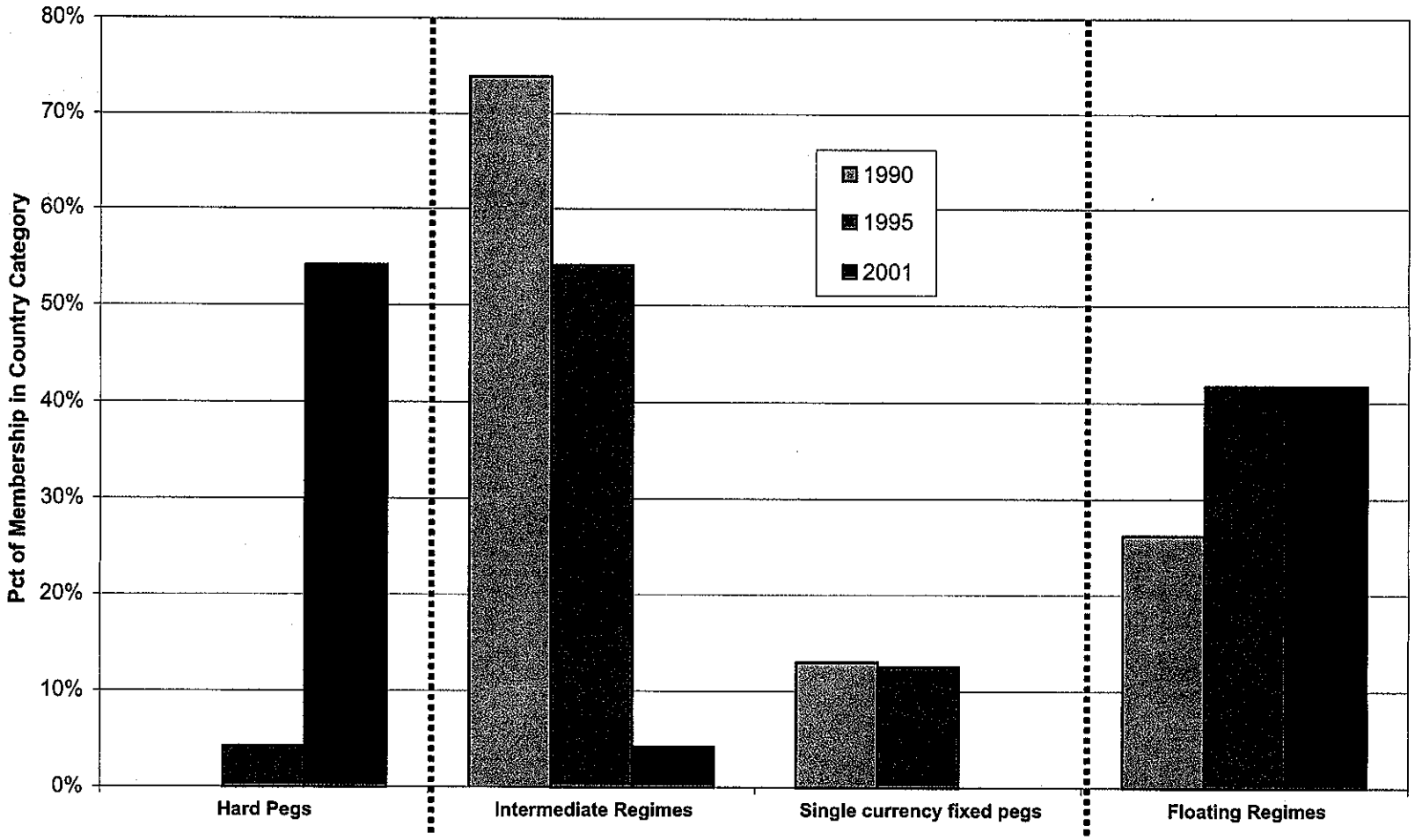
(1) Definition of developed countries coincide with the classification used in International Financial Statistics.

(2) Emerging market countries include the following: Argentina, Brazil, Bulgaria, Chile, China, Colombia, Czech Republic, Egypt, Ecuador, Hong Kong, Hungary, India, Indonesia, Israel, Jordan, Republic of Korea, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Panama, Philippines, Poland, Russia, Singapore, South Africa, Sri Lanka, Thailand, Turkey and Venezuela.

SOURCE: IMF.

CHART 5A

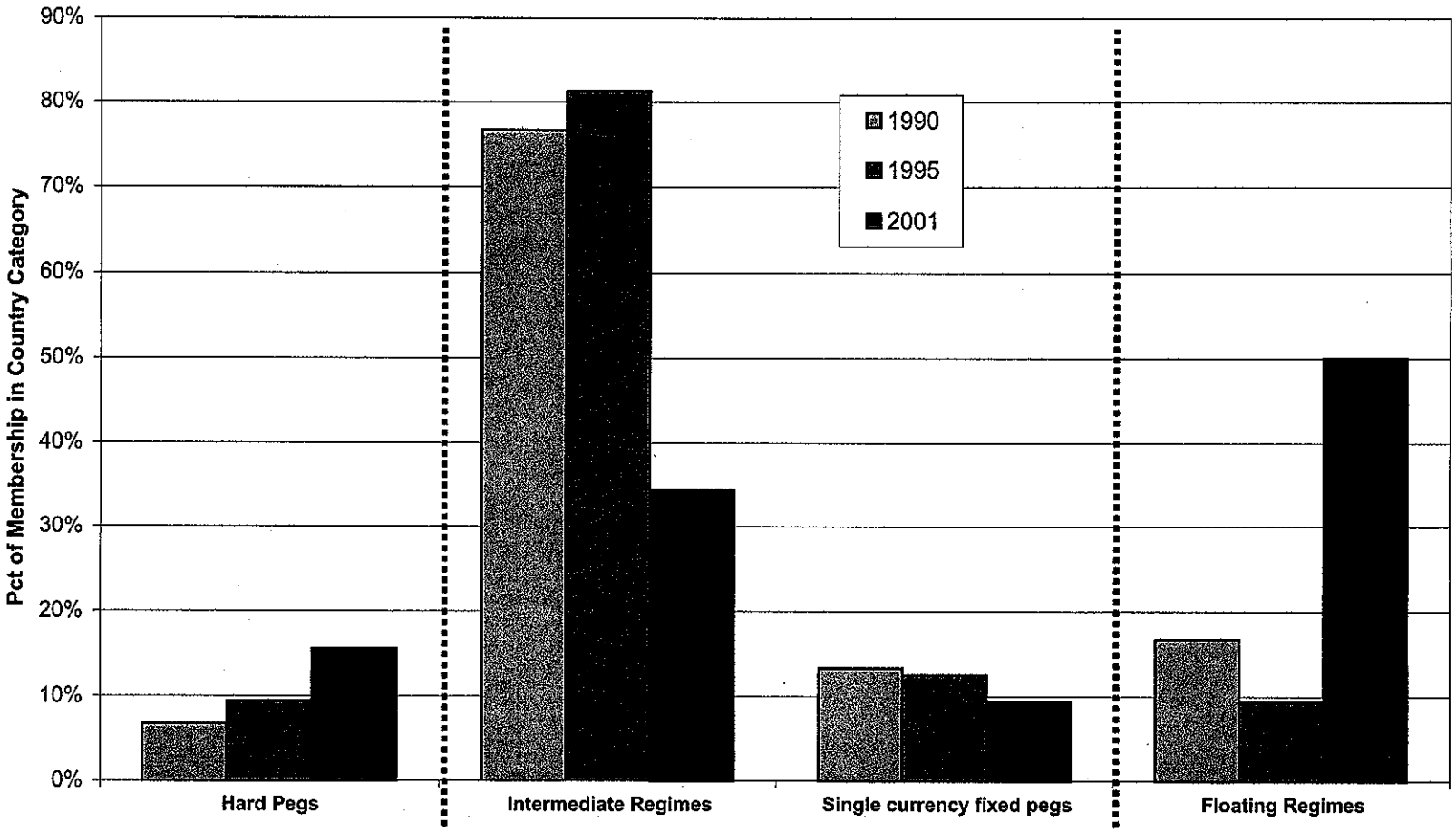
Developed Countries -- Evolution of Exchange-Rate Regime Types, 1990-2001



NOTE: See Table 4. Percentage for hard pegs in 1990 and single-currency-fixed pegs in 2001 = 0% and are not visible on chart.

CHART 5B

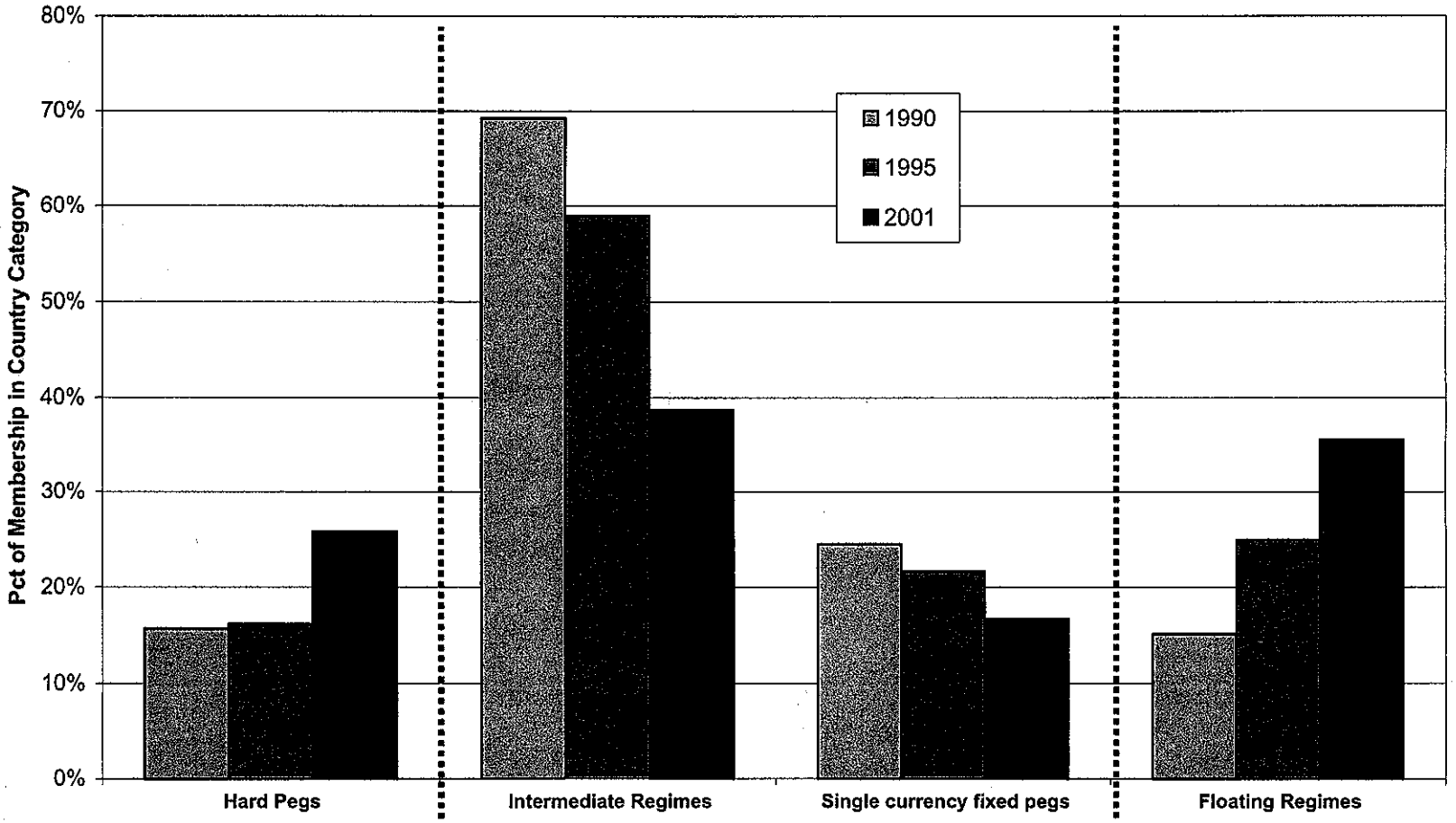
Emerging Market Countries -- Evolution of Exchange-Rate Regime Types, 1990-2001



NOTE: See Table 4.

CHART 5C

All Member Countries -- Evolution of Exchange-Rate Regime Types, 1990-2001



NOTE: See Table 4.

Table 5

Summary of Major Foreign Currency Crises Since 1990 and Effect on Currency Regime Types

Country Involved	Pre-Crisis Foreign-Exchange Regime		Period of Crisis	Post-Crisis Foreign-Exchange Regime	
	Regime Grouping	Specific Regime Type		Regime Grouping	Specific Regime Type
Argentina	Hard peg	Currency board	2001-2002	Floating regime	Managed float
Brazil	Intermediate regime	Crawling peg	1999	Floating regime	Free float
Ecuador	Intermediate regime	Crawling band	1999	Hard peg	Dollarization
Indonesia	Intermediate regime	Crawling band	1997	Floating regime	Free float
Malaysia	Intermediate regime	Closely managed float	1997	Intermediate	Conventional fixed peg
Mexico	Intermediate regime	Crawling band	1994	Floating regime	Free float
Russia	Intermediate regime	Crawling peg	1998	Floating regime	Managed float
Thailand	Intermediate regime	Basket peg	1997	Floating regime	Managed float
Turkey	Intermediate regime	Crawling peg	1994, 2001	Floating regime	Free float

SOURCE: IMF.

Exhibit 2

Detailed Listing of Capital Controls (to be furnished)

Summary of China's Capital Controls By Category and Flow Type

CAPITAL FLOW TYPE	APPLIES TO:			TYPE OF RESTRICTION/CONTROL:			REGULATING AGENCIES:				
	Residents	Non-Residents	Prohibited	Prior Approval	Registration/Monitoring	Limits / Exceptions	SAFE/PBC	MOFTEC	State Council & Govts	CSRC	
CAPITAL ACCOUNT INFLOWS											
Foreign Direct Investment (into China)					X		X	X			
Repatriation of investment profits (out of China)				X	X		X				
Liquidation of investment (out of China)				X	X		X				
Portfolio Investments											
Capital and Money Market Securities											
Purchase of equity in China										X	
Sale/issue of equity abroad				X					X	X	
Purchase of debt/money mkt securities in China											
Sale/issue of debt/money mkt securities abroad				X	X		X		X		
Early repayment of foreign debt							X				
Derivatives and Other Instruments											
Purchase in China											
Sale/issue abroad				X			X				
Credit Operations											
Commercial and financial credit											
To Residents from Non-Residents				X	X		X				
Early repayment				X	X		X				
Foreign loan guarantees for yuan-denominated loans to domestic enterprises											
Foreign loan guarantees for yuan-denominated loans to foreign enterprises											
To Foreign Enterprises from Non-Residents											
Deposit Accounts											
Non-Residents in foreign currency											
Non-Residents in yuan											
Personal Capital Movements											
Loans from Non-Residents to Residents											
Gifts from Non-Residents to Residents				X	X		X				

Summary of China's Capital Controls By Category and Flow Type

CAPITAL FLOW TYPE	APPLIES TO:			TYPE OF RESTRICTION/CONTROL:			REGULATING AGENCIES:			
	Residents	Non-Residents	Prohibited	Prior Approval	Registration/Monitoring	Limits / Exceptions	SAFE/PBC	MOFTEC	State Council & Govts	CSRC
CAPITAL ACCOUNT OUTFLOWS										
Foreign Direct Investment (abroad)				X	X		X	X		
Repatriation of investment profits (to China)										
Liquidation of investment (to China)										
Sale of Real Estate										
Originally purchased with foreign exchange				X			X			
Originally purchased with yuan										
Portfolio Investments										
Capital and Money Market Securities										
Sale/issue of equity in China										
Purchase of equity abroad				X	X		X		X	
Sale/issue of debt/money mkt securities in China										
Purchase of debt/money mkt securities abroad							X			
Derivatives and Other Instruments										
Sale/issue in China										
Purchase abroad							X			
Credit Operations										
Commercial and financial credit										
Residents to Non-Residents							X			
Foreign loan guarantees for foreign currency loans							X			
Deposit Accounts										
Residents abroad										
Residents in foreign currency										
Personal Capital Movements										
Loans from Residents to Non-Residents										
Gifts/inheritances from Residents to Non-Residents							X			

Notes and Explanation

Background

The first page of the matrix focuses on capital account outflows from China, while the second page refers to capital account inflows into China. The capital accounts (both outflows and inflows) shown in the matrix are not exhaustive, but include the following major categories: 1) foreign direct investment; 2) real estate; 3) portfolio investments; 4) credit operations; 5) deposit accounts; and, 6) personal capital movements.

For each account and flow type, three different groupings of information are provided: 1) whether the subject restrictions apply to residents or non-residents; 2) the applicable type of restrictions or control, ranging from monitoring to prohibition; and, 3) the agency of the Chinese government responsible for regulating the capital account and flow type.

Conclusion

The matrix covers most of the major accounts and flows but is neither completely exhaustive nor comprehensive as to specific details, limits, exceptions, requirements, etc; rather, the matrix is intended to illustrate the wide ranging and extensive control on capital account transactions maintained by China, rather than constitute an authoritative reference. As shown, nearly all major capital outflows are subject to either outright prohibitions or prior approvals by the government. China's control of capital inflows, while somewhat more liberalized in comparison to capital outflows, are still subject to extensive restrictions, including many standing prohibitions.

While outright prohibitions continue to constrain many aspects of the capital account, it is worth noting that the government retains nearly full discretion in the other aspects of the capital account, either by prior approval, monitoring and registration, special authorization or other means of control. In short, there are few if any aspects of the capital account that are free from restrictions and completely transparent to either resident or non-resident investors (although there is a distinct bias in favor of non-resident investors). The government has reserved the right to make changes or impose limitations and restrictions as it sees fit, depending on transient market conditions or even policy goals. Thus, for instance, in periods when there is upward pressure on the foreign-exchange value of the yuan, the government can tilt the capital controls toward greater outflows and lesser inflows (i.e., decrease demand for yuan). Similarly, in periods when there is downward pressure on the foreign exchange value of the yuan, the government can tilt the capital controls toward greater inflows and lesser outflows (i.e., increase demand for the yuan).

On balance in recent years, these controls have generally encouraged capital inflows and discouraged capital outflows. More specifically, China has strongly encouraged foreign direct investment inflows (e.g., fixed asset investment), which tend to be or less liquid and longer-term in nature, while discouraging foreign portfolio inflows (e.g., investment in Chinese stocks and bonds), which tend to be more liquid and shorter-term in nature. Similarly, China has imposed tight restrictions on short-term foreign borrowing, while taking a more liberal stance toward medium and longer-term foreign debt.

Abbreviations Used in the Matrix

SAFE	State Authority for Foreign Exchange
PBC	People's Bank of China
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
CSRC	China Securities Regulatory Committee

Sources

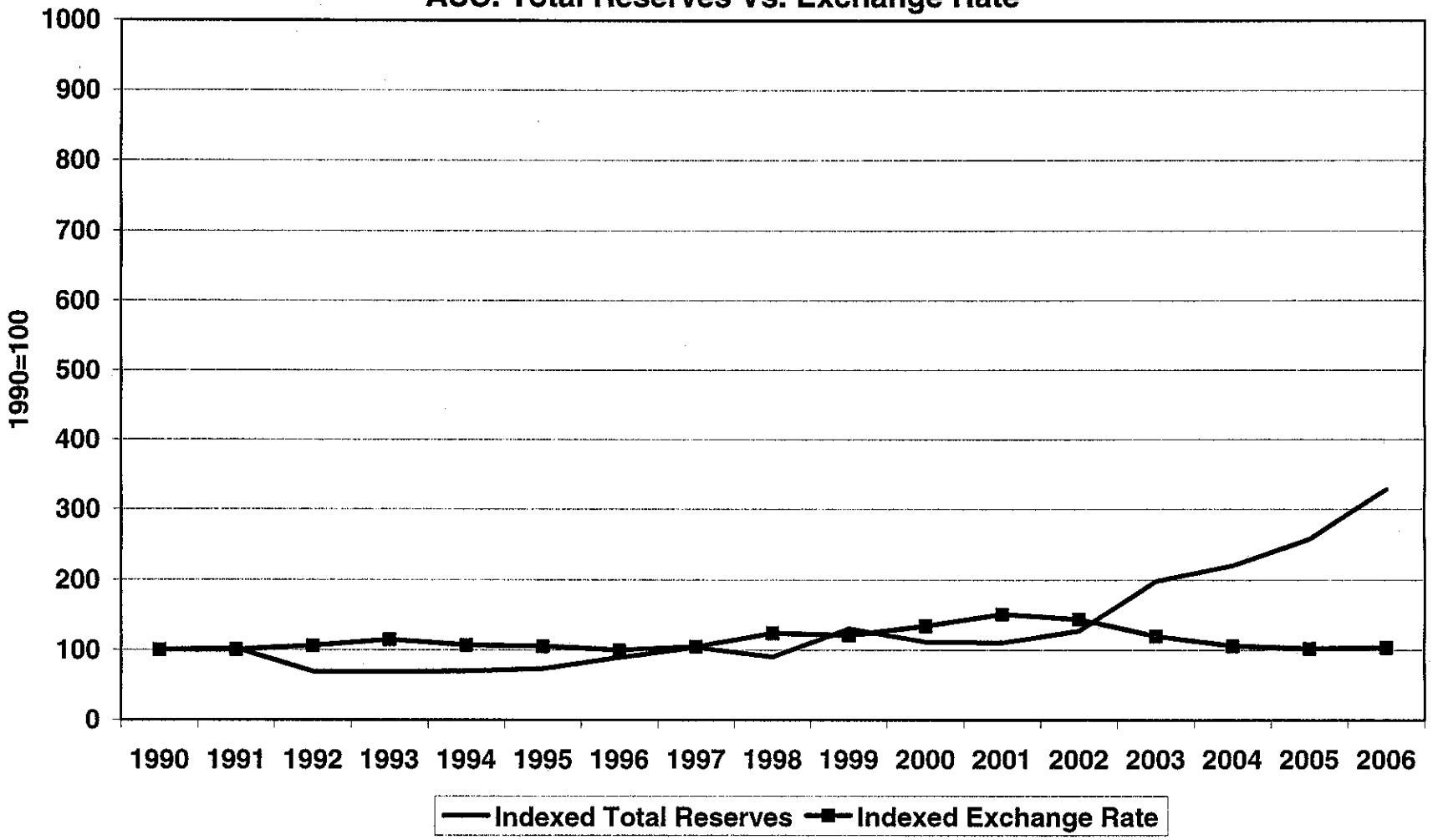
1) Guijun, Lin and Ronald M. Schramm. May 2003. "China's Foreign Exchange Policies Since 1979: A Review of Developments and an Assessment." University of International Business and Economics, Beijing.

2) Shen, Jian-Guang. Undated. "China's Exchange-rate System after WTO Accession: Some Considerations." Bank of Finland, Institute for Economies in Transition.

3) Zhang, Zhaoyong. December 1999. "Foreign Exchange Rate Reform, the Balance of Trade and Economic Growth: An Empirical Analysis for China," Journal of Economic Development (Vol. 24, No. 2) at 143-162.

EXHIBIT 2

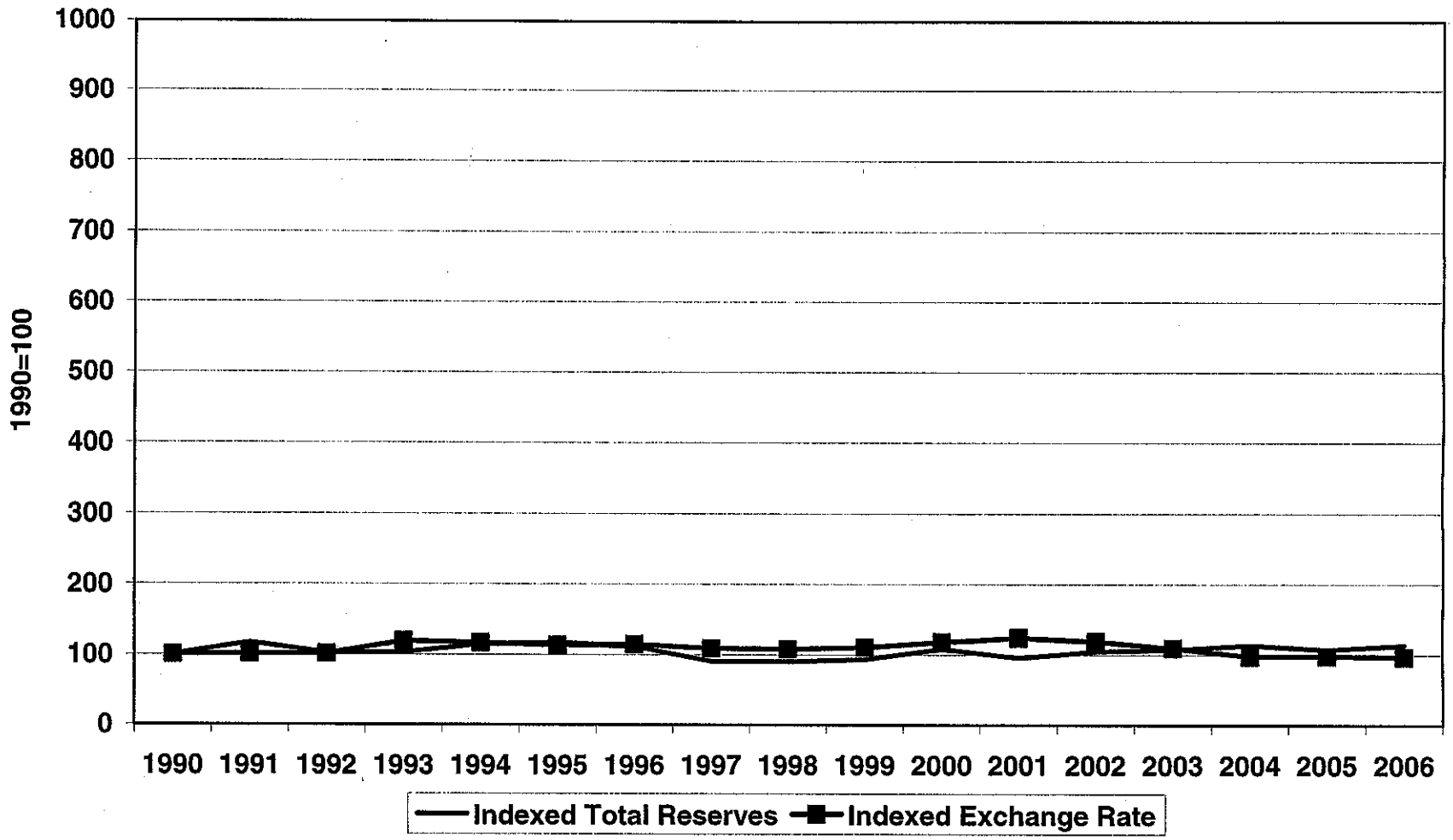
Chart 1
AUS: Total Reserves Vs. Exchange Rate



Prepared by Georgetown Economic Services

Source: IMF International Financial Statistics

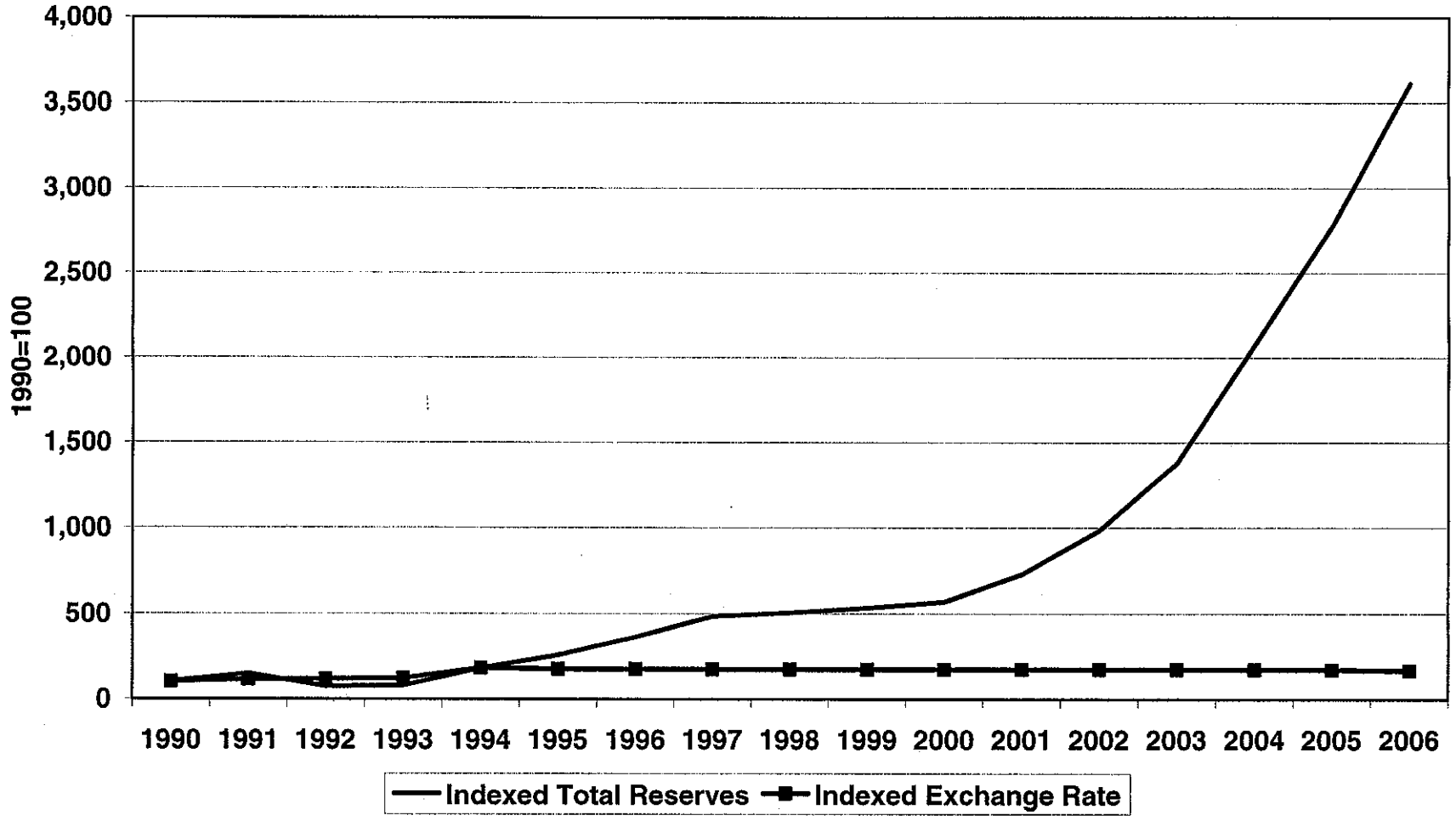
Chart 2
UK: Total Reserves Vs. Exchange Rate



Prepared by Georgetown Economic Services

Source: IMF International Financial Statistics

Chart 3
China: Total Reserves Vs. Exchange Rate



Prepared by Georgetown Economic Services

Source: IMF International Financial

EXHIBIT 3

TABLE 1: CHINA'S BALANCE OF TRADE WITH THE UNITED STATES

Annual 1995-2006
All Commodities
FOB Values In US Dollars

TABLE 1A: AS REPORTED BY CHINA

CHINA DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	15,312,376,604	15,347,132,849	15,473,368,013	16,147,097,632	18,513,316,722	21,246,377,160	24,893,412,619	25,866,505,421	32,188,814,081	42,420,027,871	46,298,227,096	56,261,348,818
Chinese Exports	24,713,497,878	26,683,100,907	32,702,663,287	37,964,973,088	42,015,984,348	52,142,000,913	54,318,910,896	69,959,401,299	92,510,148,387	124,973,451,732	162,938,722,190	203,516,389,505
Chinese Surplus:	**9,401,121,274**	**11,335,968,058**	**17,229,295,274**	**21,817,875,456**	**23,502,667,626**	**30,895,623,753**	**29,425,498,278**	**44,092,895,878**	**60,321,334,306**	**82,553,423,861**	**116,640,495,095**	**147,255,040,687**

Source: GTIS Global Trade Atlas--Data Reported by China
** Imports valued at CIF less 5% to approximate FOB values.*

TABLE 1B: AS REPORTED BY THE UNITED STATES

US DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	11,612,547,215	11,801,242,997	12,533,478,742	13,908,495,969	12,584,898,241	15,335,341,048	17,959,041,258	20,552,991,012	26,706,938,428	32,606,282,625	38,856,660,535	51,624,064,793
Chinese Exports	45,369,985,492	51,209,375,856	61,995,926,355	70,815,035,767	81,522,281,394	99,580,514,118	102,069,326,282	124,795,665,331	151,620,143,845	196,159,513,413	242,637,963,605	287,052,416,194
Chinese Surplus:	**33,757,438,277**	**39,408,132,859**	**49,462,447,613**	**56,906,539,798**	**68,937,383,153**	**84,245,173,070**	**84,110,285,024**	**104,242,674,319**	**124,913,205,417**	**163,553,230,788**	**203,781,303,070**	**235,428,351,401**

Source: Official Statistics of the U.S. Department of Commerce

TABLE 2: CHINA'S BALANCE OF TRADE WITH THE UNITED STATES ADJUSTED FOR HONG KONG RE-EXPORT TRADE

Annual 2001-2006
All Commodities
FOB Values in US Dollars

TABLE 2A: AS REPORTED BY CHINA

CHINA DATA:	2001	2002	2003	2004	2005	2006
Chinese Imports*	24,505,095,799	25,494,144,821	31,814,079,641	42,072,383,415	45,935,781,924	55,868,911,747
Chinese Exports	79,283,425,146	95,714,488,299	117,603,251,637	151,630,583,039	191,677,750,817	233,620,154,051
Chinese Surplus:	**54,778,329,348**	**70,220,343,478**	**85,789,171,996**	**109,558,199,624**	**145,741,968,893**	**177,751,242,304**

Source: GTIS Global Trade Atlas--Data Reported by China, US ITC
** Imports valued at CIF less 5% to approximate FOB values.*

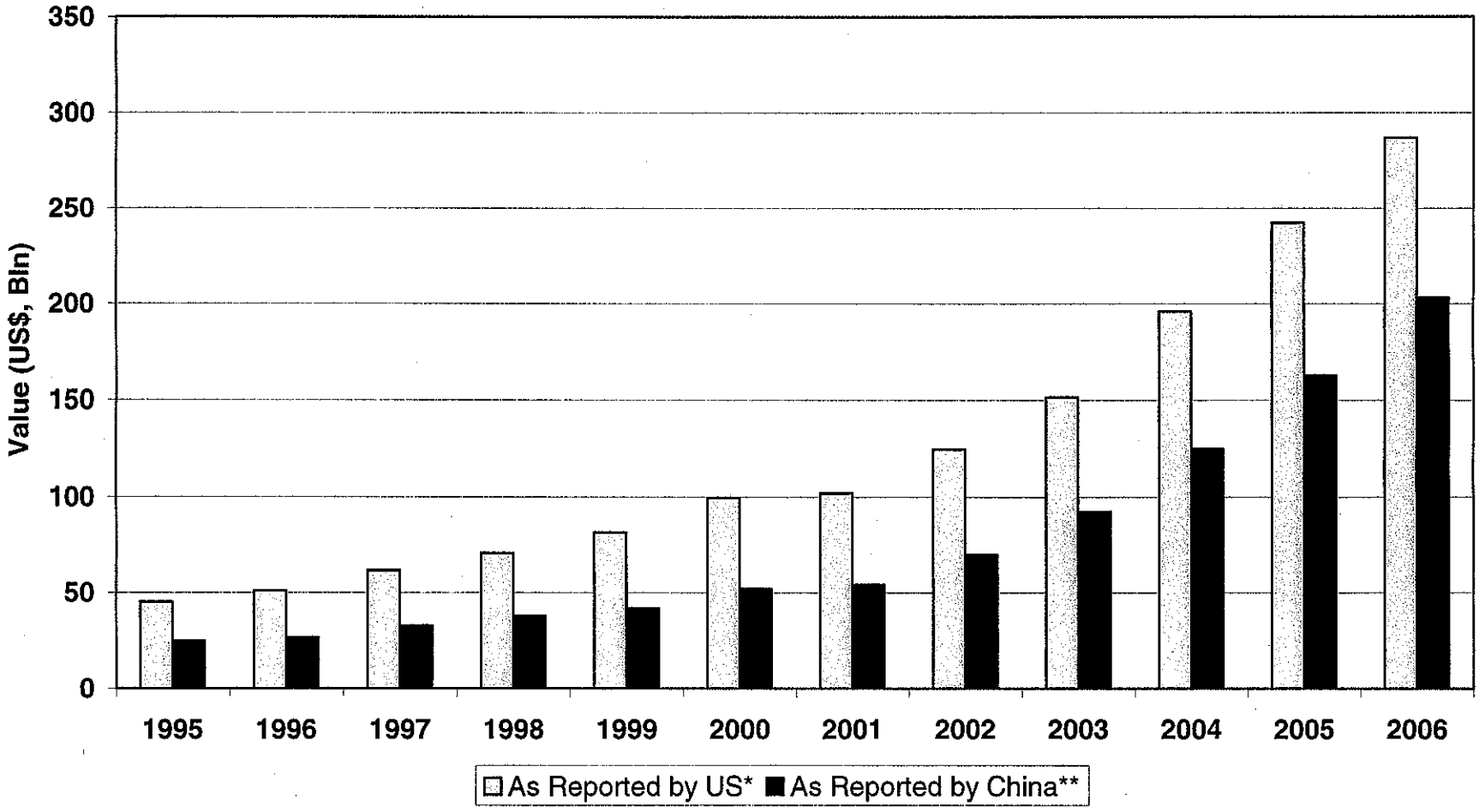
TABLE 2B: AS REPORTED BY THE UNITED STATES

US DATA:	2001	2002	2003	2004	2005	2006
Chinese Imports	24,042,671,438	26,386,640,412	32,577,777,988	38,052,712,442	44,534,968,224	57,772,245,573
Chinese Exports	93,747,821,532	116,210,636,331	143,255,776,095	187,273,802,977	233,058,287,396	277,017,828,012
Chinese Surplus:	**69,705,150,094**	**89,823,995,919**	**110,677,998,107**	**149,221,090,536**	**188,523,319,172**	**219,245,582,439**

Source: Official Statistics of the U.S. Department of Commerce

SEE "Methodological Explanation" at the end of this section for additional explanation and details.

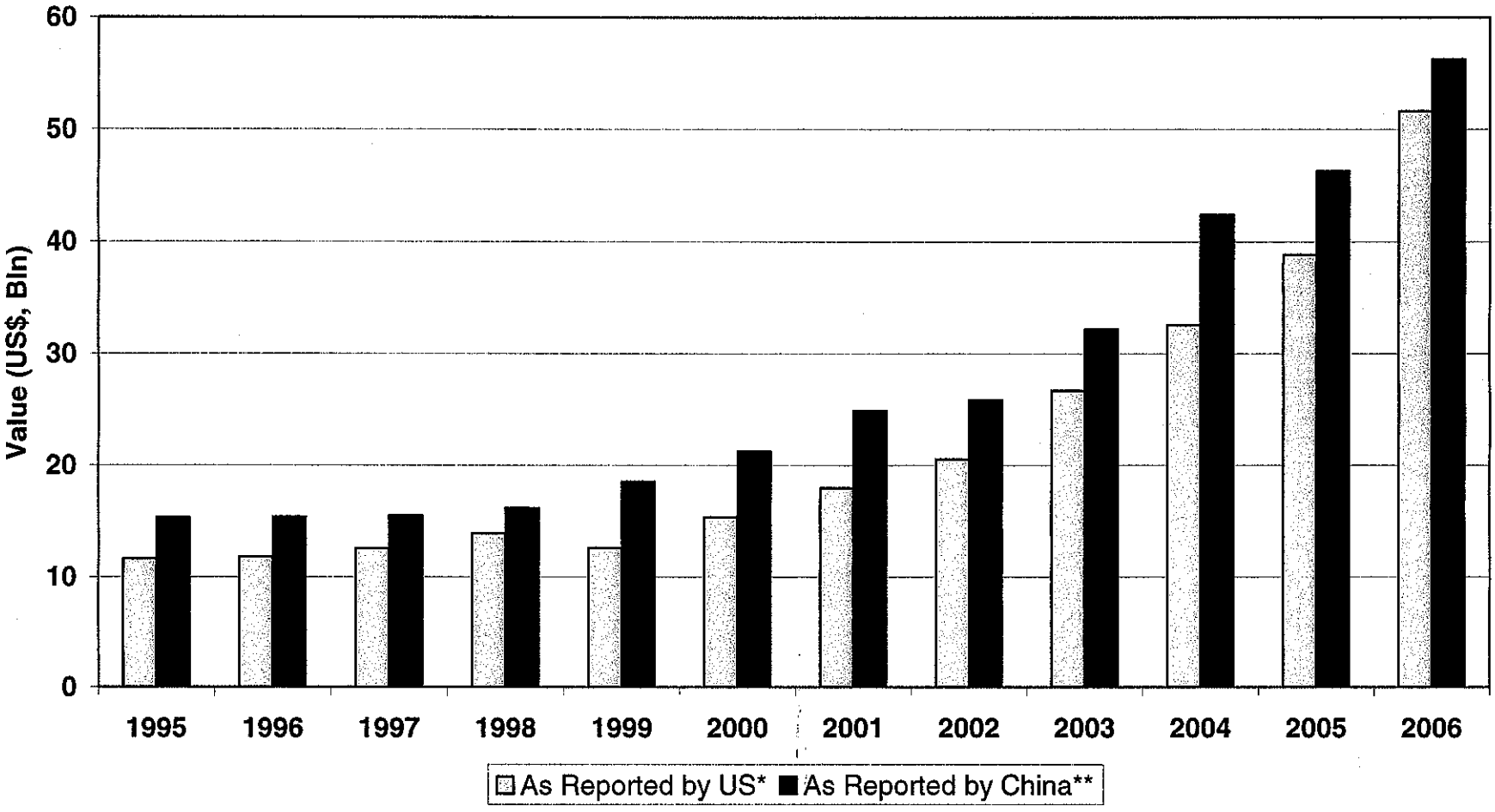
Chart 1:
Chinese Exports to the United States, as Reported by China and the United States



* - Source: US DOC; US Imports valued at C.V.
** - Source: China Customs; Exports to US valued at F.O.B.

Prepared by Georgetown Economic Services

Chart 2:
Imports to China, as Reported by China and the United States



* - Source: US DOC; US exports valued at F.O.B.
** - Source: China Customs; Imports from US valued at C.I.F. less 5%

Prepared by Georgetown Economic Services

TABLE 3: CHINA'S BALANCE OF TRADE BASED UPON DATA FROM VARIOUS SOURCES USING 5% CIF/FOB DEFLATOR

Annual 1995-2006 or as noted
All Commodities
FOB Values in US Dollars

TABLE 3A: AS REPORTED BY THE IMF FOR ALL TRADING PARTNERS

IMF DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	110,060,000,000	131,542,000,000	136,448,000,000	136,915,000,000	158,734,000,000	214,657,000,000	232,058,000,000	281,484,000,000	393,618,000,000	534,410,000,000	628,295,000,000	-
Chinese Exports	128,110,000,000	151,077,000,000	182,670,000,000	183,529,000,000	194,716,000,000	249,131,000,000	266,075,000,000	325,651,000,000	438,270,000,000	593,393,000,000	762,484,000,000	-
Chinese Surplus:	18,050,000,000	19,535,000,000	46,222,000,000	46,614,000,000	35,982,000,000	34,474,000,000	34,017,000,000	44,167,000,000	44,652,000,000	58,983,000,000	134,189,000,000	-

Source: IMF, International Financial Statistics--Data Reported by China

TABLE 3B: AS REPORTED BY CHINA FOR ALL TRADING PARTNERS

CHINA DATA (ALL):

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	125,479,269,594	131,891,136,920	135,032,861,510	133,366,082,170	157,490,138,667	213,840,385,165	231,388,697,168	280,537,760,042	392,440,834,852	532,770,616,602	627,210,677,737	752,204,205,295
Chinese Exports	148,779,564,595	151,047,526,432	182,743,907,761	183,746,494,181	195,176,530,901	249,239,664,195	266,661,113,296	325,642,067,334	438,472,556,679	593,647,174,142	762,326,759,874	969,323,615,439
Chinese Surplus:	23,300,295,001	19,156,389,512	47,711,046,251	50,380,412,011	37,686,392,234	35,399,279,030	35,272,416,128	45,104,307,292	46,031,721,827	60,876,557,540	135,116,082,137	217,119,410,144

Source: GTIS Global Trade Atlas--Data Reported by China
** Imports valued at CIF less 5% to approximate FOB values.*

TABLE 3C: AS REPORTED BY CHINA FOR 39 PARTNER COUNTRIES

CHINA DATA (39 PARTNERS):

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	117,385,317,553	122,509,341,182	123,596,587,537	124,269,836,629	145,996,202,847	190,049,050,263	208,702,851,755	254,385,053,243	352,737,346,356	472,637,693,066	517,228,581,662	650,337,857,417
Chinese Exports	134,204,732,555	137,063,436,259	165,194,744,070	165,102,434,877	174,931,432,331	221,659,601,087	235,396,239,205	286,799,240,386	383,945,770,537	519,433,181,905	662,020,768,877	825,009,799,206
Chinese Surplus:	16,819,415,002	14,554,095,077	41,598,156,533	40,832,598,248	28,935,229,484	31,610,550,824	26,693,387,450	32,414,187,143	31,208,424,181	46,795,488,839	144,792,187,215	174,671,941,789

Source: GTIS Global Trade Atlas--Data Reported by China (See Table 7 for list of 39 partner countries).
** Imports valued at CIF less 5% to approximate FOB values.*

TABLE 3D: AS REPORTED BY 39 PARTNER COUNTRIES

39 PARTNER DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	-	-	-	-	150,990,740,430	189,155,592,329	201,099,170,240	246,045,671,759	338,490,543,089	438,845,374,735	512,660,087,330	611,700,571,820
Chinese Exports*	-	-	-	-	291,425,022,494	360,510,947,042	370,515,367,624	435,168,562,296	549,396,188,057	724,609,795,477	897,879,008,499	1,081,829,384,747
Chinese Surplus:	-	-	-	-	140,434,282,064	171,355,354,713	169,416,197,384	189,122,890,537	210,905,644,968	285,758,360,742	385,218,921,169	470,128,812,927

Source: GTIS Global Trade Atlas--Data Reported by Partner Countries (See Table 7 for list of 39 partner countries).
** Exports (Partner-reported imports) valued at CIF less 5% to approximate FOB values.*

TABLE 3E: AS REPORTED BY THE UN (REPORTED TO UN BY 39 PARTNER COUNTRIES)

UN DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	-	-	-	-	152,966,813,745	191,826,258,232	203,289,259,022	248,943,384,025	-	-	-	-
Chinese Exports*	-	-	-	-	292,382,812,004	362,240,775,085	372,301,897,374	437,364,358,780	-	-	-	-
Chinese Surplus:	-	-	-	-	139,415,998,259	170,414,516,853	169,012,638,352	188,420,974,755	-	-	-	-

Source: UN Comtrade Database--Data Reported by Partner Countries (See Table 7 for list of 39 partner countries).
** Exports (Partner-reported imports) valued at CIF less 5% to approximate FOB values.*

TABLE 4: CHINA'S BALANCE OF TRADE BASED UPON DATA FROM VARIOUS SOURCES USING 10% CIF/FOB DEFLATOR

Annual 1995-2006 or as noted
All Commodities
FOB Values in US Dollars

TABLE 4A: AS REPORTED BY THE IMF FOR ALL TRADING PARTNERS

IMF DATA:	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	110,060,000,000	131,542,000,000	136,448,000,000	136,915,000,000	158,734,000,000	214,657,000,000	232,058,000,000	281,484,000,000	393,618,000,000	534,410,000,000	628,295,000,000	-
Chinese Exports	128,110,000,000	151,077,000,000	182,670,000,000	183,529,000,000	194,716,000,000	249,131,000,000	266,075,000,000	325,651,000,000	438,270,000,000	593,393,000,000	762,484,000,000	-
Chinese Surplus:	18,050,000,000	19,535,000,000	46,222,000,000	46,614,000,000	35,982,000,000	34,474,000,000	34,017,000,000	44,167,000,000	44,652,000,000	58,983,000,000	134,189,000,000	-

Source: IMF, International Financial Statistics--Data Reported by China

TABLE 4B: AS REPORTED BY CHINA FOR ALL TRADING PARTNERS

CHINA DATA (ALL):	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	118,875,097,510	124,949,498,135	127,925,868,799	126,346,814,688	149,201,184,001	202,585,628,051	219,210,344,686	265,772,614,776	371,786,054,071	504,730,057,834	594,199,589,435	712,614,510,280
Chinese Exports	148,779,564,595	151,047,526,432	182,743,907,761	183,746,494,181	195,176,530,901	249,239,664,195	266,661,113,295	325,642,067,334	438,472,556,679	593,647,174,142	762,326,759,874	969,323,615,439
Chinese Surplus:	29,904,467,085	26,098,028,298	54,818,038,962	57,399,679,493	45,975,346,900	46,654,036,144	47,450,768,610	59,869,452,558	66,686,502,608	88,917,116,308	168,127,170,439	256,709,105,159

Source: GTIS Global Trade Atlas--Data Reported by China
** Imports valued at CIF less 10% to approximate FOB values.*

TABLE 4C: AS REPORTED BY CHINA FOR 39 PARTNER COUNTRIES

CHINA DATA (39 PARTNERS):	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	111,207,142,945	116,061,481,120	117,091,503,983	117,729,318,911	138,312,192,171	180,046,468,670	197,718,491,137	240,996,366,230	334,172,222,863	447,762,025,010	490,006,024,733	616,109,549,132
Chinese Exports	134,204,732,555	137,063,436,259	165,194,744,070	165,102,434,877	174,931,432,331	221,659,601,087	235,396,239,205	286,799,240,386	383,945,770,537	519,433,181,905	662,020,768,877	825,009,799,206
Chinese Surplus:	22,997,589,610	21,001,955,139	48,103,240,087	47,373,115,966	36,619,240,160	41,613,132,417	37,677,748,068	45,802,874,156	49,773,547,674	71,671,156,895	172,014,744,144	208,900,250,074

Source: GTIS Global Trade Atlas--Data Reported by China (See Table 7 for list of 39 partner countries).
** Imports valued at CIF less 10% to approximate FOB values.*

TABLE 4D: AS REPORTED BY 39 PARTNER COUNTRIES

39 PARTNER DATA:	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	-	-	-	-	150,990,740,430	189,155,592,329	201,099,170,240	246,045,671,759	338,490,543,089	438,845,374,735	512,660,087,330	611,700,571,820
Chinese Exports*	-	-	-	-	281,216,318,773	347,830,672,339	357,546,234,471	420,370,664,513	530,603,599,285	699,895,306,324	867,349,554,567	1,045,082,048,048
Chinese Surplus:	-	-	-	-	130,225,578,343	158,675,080,010	156,447,064,231	174,324,992,754	192,113,056,196	261,049,931,589	354,689,467,237	433,381,476,228

Source: GTIS Global Trade Atlas--Data Reported by Partner Countries (See Table 7 for list of 39 partner countries).
** Exports (Partner-reported imports) valued at CIF less 10% to approximate FOB values.*

TABLE 4E: AS REPORTED BY THE UN (REPORTED TO UN BY 39 PARTNER COUNTRIES)

UN DATA:	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	-	-	-	-	152,966,813,745	191,826,258,232	203,289,259,022	248,943,384,025	-	-	-	-
Chinese Exports*	-	-	-	-	282,127,402,573	349,476,816,560	359,256,346,284	422,461,372,893	-	-	-	-
Chinese Surplus:	-	-	-	-	129,160,588,828	157,650,558,328	155,967,087,262	173,517,988,868	-	-	-	-

Source: UN Comtrade Database--Data Reported by Partner Countries (See Table 7 for list of 39 partner countries).
** Exports (Partner-reported imports) valued at CIF less 10% to approximate FOB values.*

TABLE 5: CHINA'S BALANCE OF TRADE BASED UPON DATA FROM VARIOUS SOURCES USING 5% CIF/FOB DEFLATOR, ADJUSTED FOR HONG KONG RE-EXPORT TRADE (1)

Annual 1995-2006 or as noted
All Commodities
FOB Values in US Dollars

TABLE 5A: AS REPORTED BY THE IMF FOR ALL TRADING PARTNERS

IMF DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	110,060,000,000	131,542,000,000	136,448,000,000	136,915,000,000	158,734,000,000	214,657,000,000	232,058,000,000	281,484,000,000	393,618,000,000	534,410,000,000	628,295,000,000	-
Chinese Exports	128,110,000,000	151,077,000,000	182,670,000,000	183,529,000,000	194,716,000,000	249,131,000,000	266,075,000,000	325,651,000,000	438,270,000,000	593,393,000,000	762,484,000,000	-
Chinese Surplus:	18,050,000,000	19,535,000,000	46,222,000,000	46,614,000,000	35,982,000,000	34,474,000,000	34,017,000,000	44,167,000,000	44,652,000,000	58,983,000,000	134,189,000,000	-

Source: IMF, International Financial Statistics--Data Reported by China

TABLE 5B: AS REPORTED BY CHINA FOR ALL TRADING PARTNERS

CHINA DATA (ALL):

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	125,479,269,594	131,691,136,920	135,032,861,510	133,366,082,170	157,490,138,667	213,840,385,185	231,388,697,168	280,537,760,042	392,440,834,852	532,770,616,602	627,210,677,737	752,204,205,295
Chinese Exports	148,779,564,595	151,047,526,432	182,743,907,761	183,746,494,181	195,176,530,901	249,239,664,195	266,661,113,296	325,642,067,334	438,472,556,679	593,647,174,142	762,326,759,874	969,323,615,439
Chinese Surplus:	23,300,295,001	19,156,389,512	47,711,046,251	50,380,412,011	37,686,392,234	35,399,279,030	35,272,416,128	45,104,307,292	46,031,721,827	60,876,557,540	135,116,082,137	217,119,410,144

GDP	1,303,568,256,615	1,903,043,410,380
Surplus/GDP	3.46%	7.10%

Source: GTIS Global Trade Atlas--Data Reported by China
** Imports valued at CIF less 5% to approximate FOB values.*

TABLE 5C: AS REPORTED BY CHINA FOR 39 PARTNER COUNTRIES

CHINA DATA (39 PARTNERS):

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	117,385,317,553	122,509,341,182	123,596,587,537	124,269,836,629	145,996,202,847	190,049,050,263	208,702,851,755	254,385,053,243	352,737,346,356	472,637,693,066	517,228,581,662	650,337,857,417
Chinese Exports	134,204,732,555	137,063,436,259	165,194,744,070	165,102,434,877	174,931,432,331	221,659,601,087	235,396,239,205	286,799,240,386	383,945,770,537	519,433,181,905	662,020,768,877	825,009,799,206
Chinese Surplus:	16,819,415,002	14,554,095,077	41,598,156,533	40,832,598,248	28,935,229,484	31,610,550,824	26,693,387,450	32,414,187,143	31,208,424,181	46,795,488,839	144,792,187,215	174,671,941,789

Source: GTIS Global Trade Atlas--Data Reported by China (See Table 7 for list of 39 partner countries).
** Imports valued at CIF less 5% to approximate FOB values.*

TABLE 5D: AS REPORTED BY 39 PARTNER COUNTRIES

39 PARTNER DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	-	-	-	-	102,505,305,638	130,023,942,041	141,068,700,888	176,953,880,986	253,105,323,225	335,947,021,889	395,446,649,196	476,401,857,766
Chinese Exports*	-	-	-	-	222,077,584,244	278,592,890,042	292,691,648,600	351,986,869,546	456,112,413,290	615,164,385,273	771,098,366,760	940,624,977,140
Chinese Surplus:	-	-	-	-	119,572,278,606	148,568,948,001	151,622,947,712	175,032,988,560	203,007,090,065	279,217,363,384	375,651,717,564	464,223,119,373

Surplus/GDP	13.43%		19.74%
		Change	6.31%

Source: GTIS Global Trade Atlas--Data Reported by Partner Countries (See Table 7 for list of 39 partner countries).
** Exports (Partner-reported imports) valued at CIF less 5% to approximate FOB values.*

TABLE 5E: AS REPORTED BY THE UN (REPORTED TO UN BY 39 PARTNER COUNTRIES)

UN DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	-	-	-	-	104,481,378,953	132,694,607,944	143,258,769,670	179,851,593,252	-	-	-	-
Chinese Exports*	-	-	-	-	223,035,379,754	280,322,718,085	294,478,178,350	354,182,666,031	-	-	-	-
Chinese Surplus:	-	-	-	-	118,553,994,802	147,628,110,141	151,219,388,680	174,331,072,779	-	-	-	-

Source: UN Comtrade Database--Data Reported by Partner Countries (See Table 7 for list of 39 partner countries).
** Exports (Partner-reported imports) valued at CIF less 5% to approximate FOB values.*

NOTE: (1) The adjustment for Hong Kong re-export trade was only required for data reported by the partner countries (Tables 5D and 5E).

TABLE 6: CHINA'S BALANCE OF TRADE, BY VARIOUS SOURCES USING 10% CIF/FOB DEFLATOR, ADJUSTED FOR HONG KONG RE-EXPORT TRADE (1)

Annual 1995-2006 or as noted
All Commodities
FOB Values in US Dollars

TABLE 6A: AS REPORTED BY THE IMF FOR ALL TRADING PARTNERS (1995-2005)

IMF DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	110,060,000,000	131,542,000,000	136,448,000,000	136,915,000,000	158,734,000,000	214,657,000,000	232,058,000,000	281,484,000,000	393,618,000,000	534,410,000,000	628,295,000,000	-
Chinese Exports	128,110,000,000	151,077,000,000	182,670,000,000	183,529,000,000	194,716,000,000	249,131,000,000	266,075,000,000	325,651,000,000	438,270,000,000	593,393,000,000	762,484,000,000	-
Chinese Surplus:	18,050,000,000	19,535,000,000	46,222,000,000	46,614,000,000	35,982,000,000	34,474,000,000	34,017,000,000	44,167,000,000	44,652,000,000	58,983,000,000	134,189,000,000	-

Source: IMF, International Financial Statistics--Data Reported by China

TABLE 6B: AS REPORTED BY CHINA FOR ALL TRADING PARTNERS

CHINA DATA (ALL):

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	118,875,097,510	124,949,498,135	127,925,868,799	126,346,814,688	149,201,184,001	202,585,628,051	219,210,344,686	265,772,614,776	371,786,054,071	504,730,057,834	594,199,589,435	712,614,510,280
Chinese Exports	148,779,564,595	151,047,526,432	182,743,907,761	183,746,494,181	195,176,530,901	249,239,664,195	266,661,113,296	325,642,067,334	438,472,556,679	593,647,174,142	762,326,759,874	969,323,615,439
Chinese Surplus:	29,904,467,085	26,098,028,298	54,818,038,962	57,399,679,493	45,975,346,900	46,654,036,144	47,450,768,610	59,869,452,558	66,686,502,608	88,917,116,308	168,127,170,439	256,709,105,159

Source: GTIS Global Trade Atlas--Data Reported by China
** Imports valued at CIF less 10% to approximate FOB values.*

TABLE 6C: AS REPORTED BY CHINA FOR 40 PARTNER COUNTRIES

CHINA DATA (39 PARTNERS):

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports*	111,207,142,945	116,061,481,120	117,091,503,983	117,729,318,911	138,312,192,171	180,046,468,670	197,718,491,137	240,996,366,230	334,172,222,863	447,762,025,010	490,006,024,783	616,109,549,132
Chinese Exports	134,204,732,555	137,063,436,259	165,194,744,070	165,102,434,877	174,931,432,331	221,659,601,087	235,396,239,205	286,799,240,386	383,945,770,537	519,433,181,905	662,020,768,877	825,009,799,206
Chinese Surplus:	22,997,589,610	21,001,955,139	48,103,240,087	47,373,115,966	36,619,240,160	41,613,132,417	37,677,748,068	45,802,874,156	49,773,547,674	71,671,156,895	172,014,744,144	208,900,250,074

Source: GTIS Global Trade Atlas--Data Reported by China (See Table 7 for list of 39 partner countries).
** Imports valued at CIF less 10% to approximate FOB values.*

TABLE 6D: AS REPORTED BY 40 PARTNER COUNTRIES (1999-2005; Jan-Jun 2006)

39 PARTNER DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	-	-	-	-	102,505,305,638	130,023,942,041	141,068,700,888	176,953,880,986	253,105,323,225	335,947,021,889	395,446,640,196	476,401,857,766
Chinese Exports*	-	-	-	-	211,868,880,523	265,912,615,339	279,722,515,448	337,188,971,764	437,319,824,517	590,455,956,121	740,568,912,828	903,877,640,441
Chinese Surplus:	-	-	-	-	109,363,574,885	135,888,673,298	138,653,814,559	160,235,090,778	184,214,501,292	254,508,934,231	345,122,263,632	427,475,782,674

Source: GTIS Global Trade Atlas--Data Reported by Partner Countries (See Table 7 for list of 39 partner countries).
** Exports (Partner-reported imports) valued at CIF less 10% to approximate FOB values.*

TABLE 6E: AS REPORTED BY THE UN (REPORTED TO UN BY 40 PARTNER COUNTRIES) (1999-2002)

UN DATA:

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Chinese Imports	-	-	-	-	104,481,378,953	132,694,607,944	143,258,789,670	179,851,593,252	-	-	-	-
Chinese Exports*	-	-	-	-	212,779,964,323	267,558,759,560	281,432,627,261	339,279,680,144	-	-	-	-
Chinese Surplus:	-	-	-	-	108,298,585,370	134,864,151,616	138,173,837,590	159,428,086,892	-	-	-	-

Source: UN Comtrade Database--Data Reported by Partner Countries (See Table 7 for list of 39 partner countries).
** Exports (Partner-reported imports) valued at CIF less 10% to approximate FOB values.*

NOTE: (1) The adjustment for Hong Kong re-export trade was only required for data reported by the partner countries (Tables 6D and 6E).

TABLE 7: LIST OF 39 PARTNER COUNTRIES

1) Argentina
2) Australia
3) Austria
4) Belgium
5) Brazil
6) Canada
7) Chile
8) Colombia
9) Denmark
10) Finland
11) France
12) Germany
13) Greece
14) Hong Kong
15) Iceland
16) Ireland
17) Italy
18) Japan
19) Luxembourg
20) Malaysia
21) Mexico
22) Netherlands
23) New Zealand
24) Norway
25) Peru
26) Philippines
27) Portugal
28) Russia
29) Singapore
30) South Africa
31) South Korea
32) Spain
33) Sweden
34) Switzerland
35) Taiwan
36) Thailand
37) Turkey
38) United Kingdom
39) United States

TABLE 8

39 Partner Countries' Share of China's Trade AS REPORTED BY CHINA
Annual 1999-2006
All Commodities
FOB Values in US Dollars

CHINA DATA

CHINA'S EXPORTS TO PARTNERS	1999	2000	2001	2002	2003	2004	2005	2006
39 Countries:	$174,931,432,331	$221,659,601,087	$235,396,239,205	$286,799,240,386	$383,945,770,537	$519,433,181,905	$662,020,768,877	$825,009,799,206
All Reporting Countries:	$195,176,530,901	$249,239,664,195	$266,661,113,296	$325,642,067,334	$438,472,556,679	$593,647,174,142	$762,326,759,874	$969,323,615,439
39 Partner Countries' Share	***89.63%***	***88.93%***	***88.28%***	***88.07%***	***87.56%***	***87.50%***	***86.84%***	***85.11%***

CHINA'S IMPORTS FROM PARTNERS*	1999	2000	2001	2002	2003	2004	2005	2006
39 Countries:	$138,696,392,705	$180,546,597,750	$198,267,709,168	$241,665,800,581	$335,100,479,038	$449,005,808,413	$491,367,152,579	$617,820,964,546
All Reporting Countries:	$157,490,138,667	$213,840,385,165	$231,388,697,168	$280,537,760,042	$392,440,834,852	$532,770,616,602	$627,210,677,737	$752,204,205,295
39 Partner Countries' Share	***88.07%***	***84.43%***	***85.69%***	***86.14%***	***85.39%***	***84.28%***	***78.34%***	***82.13%***

** - Imports valued at CIF less 5% to approximate FOB values.*
SOURCE: GTIS Global Trade Atlas--Data Reported by China

TABLE 9

39 Partner Countries' Share of China's AS REPORTED BY PARTNER COUNTRIES
Annual 1999-2006
All Commodities
FOB Values in US Dollars

PARTNER DATA

CHINA'S EXPORTS TO PARTNERS*	1999	2000	2001	2002	2003	2004	2005	2006
39 Countries:	$291,425,022,494	$360,510,947,042	$370,515,367,624	$435,168,562,296	$549,396,188,057	$724,603,735,477	$897,879,008,499	$1,081,829,384,747
All Reporting Countries:	$294,110,403,819	$364,880,665,262	$375,201,346,605	$448,402,216,006	$564,021,608,628	$748,513,777,773	$919,275,737,364	$1,115,694,710,326
39 Partner Countries' Share	***99.09%***	***98.80%***	***98.75%***	***97.05%***	***97.41%***	***96.81%***	***97.67%***	***96.96%***

CHINA'S IMPORTS FROM PARTNERS	1999	2000	2001	2002	2003	2004	2005	2006
39 Countries:	$150,990,740,430	$189,155,592,329	$201,099,170,240	$246,045,671,759	$338,490,543,089	$438,845,374,735	$512,660,087,330	$611,700,571,820
All Reporting Countries:	$153,506,384,845	$192,774,177,667	$204,438,166,877	$251,394,572,601	$343,645,506,359	$450,567,932,123	$515,524,143,456	$615,389,016,100
39 Partner Countries' Share	***98.36%***	***98.12%***	***98.37%***	***97.87%***	***98.50%***	***97.40%***	***99.44%***	***99.40%***

** - Imports valued at CIF less 5% to approximate FOB values.*
SOURCE: GTIS Global Trade Atlas--Data Reported by Partner Countries
Note: The Global Trade Atlas database encompases a total of 55 reporting countries.

TABLE 10
Chinese Misstatement of Trade Balances, by Trading Partner
Trade Balances AS REPORTED BY 39 PARTNER COUNTRIES AND BY CHINA FOR THE 39 PARTNER COUNTRIES
Annual 1999-2006
All Commodities, FOB Values in US Dollars (*)

China Trade Balances

	Valuation as Reported (*)	1999	2000	2001	2002	2003	2004	2005	2006
Argentina	C.I.F.	$434,520,001	$301,973,456	-$111,163,830	-$778,625,694	-$1,793,705,271	-$1,788,862,031	-$1,740,458,723	-$1,465,802,075
Argentina (China)		-$65,392,796	-$272,497,232	-$642,877,103	-$992,215,143	-$2,145,918,945	-$2,240,762,864	-$2,284,246,529	-$1,508,098,169
Chinese Under (-)/Overstatement		-115.0%	-190.2%	478.3%	27.4%	19.6%	25.3%	31.2%	2.9%
Australia	Customs Value	$1,611,473,454	$1,744,510,240	$1,415,842,735	$2,443,109,618	$3,383,562,714	$5,082,854,211	$3,984,893,610	$3,836,218,543
Australia (China)		-$723,048,688	-$1,344,529,301	-$1,584,934,123	-$969,970,713	-$672,250,374	-$2,114,314,087	-$4,274,054,364	-$4,609,731,366
Chinese Under (-)/Overstatement		-144.9%	-177.1%	-211.9%	-139.7%	-119.9%	-141.6%	-207.3%	-220.2%
Austria	C.I.F.	$127,884,939	$206,777,444	$109,876,061	-$76,112,668	$670,417,118	$353,011,723	$530,540,019	$1,371,399,626
Austria (China)		-$170,755,175	-$141,430,983	-$275,280,297	-$366,925,108	-$376,076,754	-$654,433,960	-$647,412,303	-$903,183,285
Chinese Under (-)/Overstatement		-233.5%	-168.4%	-350.5%	382.1%	-156.1%	-285.4%	-222.0%	-165.9%
Belgium	C.I.F.	$2,039,451,867	$2,262,983,706	$2,162,365,132	$2,369,583,915	$3,362,717,885	$5,060,413,126	$6,737,057,485	$8,414,070,632
Belgium (China)		$902,209,965	$983,805,313	$913,037,823	$955,918,596	$1,305,502,650	$2,520,783,588	$3,934,145,208	$5,819,742,120
Chinese Under (-)/Overstatement		-55.8%	-56.5%	-57.8%	-59.7%	-61.2%	-50.2%	-41.6%	-30.8%
Brazil	F.O.B.	$188,900,659	$137,070,499	-$573,798,237	-$966,370,734	-$2,384,924,825	-$1,730,055,294	-$1,480,406,644	-$410,425,709
Brazil (China)		-$43,458,759	-$316,633,703	-$866,529,700	-$1,386,522,225	-$3,407,507,398	-$4,548,193,254	-$4,653,439,386	-$4,881,579,157
Chinese Under (-)/Overstatement		-123.0%	-331.0%	51.0%	43.5%	42.9%	162.9%	214.3%	1089.4%
Canada	F.O.B.	$4,232,333,193	$5,107,357,947	$5,480,317,689	$7,554,009,914	$9,919,413,803	$13,426,667,080	$18,563,943,652	$23,667,447,886
Canada (China)		$217,167,980	-$406,146,359	-$478,325,512	$858,839,492	$1,477,353,289	$1,187,159,909	$4,517,039,591	$8,236,207,430
Chinese Under (-)/Overstatement		-94.9%	-108.0%	-108.7%	-88.6%	-85.1%	-91.2%	-75.7%	-65.2%
Chile	C.I.F.	$215,360,932	-$74,910,380	-$146,403,828	-$252,061,481	-$653,023,914	-$1,458,015,865	-$1,977,310,508	-$1,621,307,958
Chile (China)		-$25,169,591	-$487,968,690	-$422,460,610	-$488,631,205	-$849,097,216	-$1,798,257,091	-$2,544,805,790	-$2,294,452,793
Chinese Under (-)/Overstatement		-111.7%	551.4%	188.6%	93.9%	30.0%	23.3%	28.7%	41.5%
Colombia	C.I.F.	$200,653,423	$306,019,815	$426,830,054	$462,983,458	$560,253,806	$864,786,793	$1,295,260,961	$1,611,756,450
Colombia (China)		$84,853,895	$125,514,958	$179,866,471	$259,418,293	$341,169,467	$464,398,029	$735,071,128	$1,245,882,836
Chinese Under (-)/Overstatement		-57.7%	-59.0%	-57.9%	-44.0%	-39.1%	-46.3%	-43.2%	-22.7%
Denmark	C.I.F.	$849,168,244	$874,964,436	$859,410,659	$853,939,335	$1,315,420,526	$1,636,206,292	$2,418,421,096	$3,030,293,673
Denmark (China)		$234,577,707	$256,995,546	$303,839,276	$312,647,619	$578,838,889	$800,636,515	$1,655,001,970	$2,405,390,510
Chinese Under (-)/Overstatement		-72.4%	-70.6%	-64.6%	-63.4%	-56.0%	-51.1%	-31.6%	-20.6%
Finland	C.I.F.	-$503,388,066	-$527,134,946	-$407,412,015	-$310,384,793	-$263,888,713	-$801,000,844	$360,600,487	$1,075,007,489
Finland (China)		-$1,375,753,346	-$1,398,383,764	-$1,345,427,146	-$283,083,991	-$26,294,809	-$367,309,159	$1,129,728,659	$1,990,187,802
Chinese Under (-)/Overstatement		173.3%	165.3%	230.2%	-8.8%	-90.0%	-54.1%	213.3%	85.1%
France	C.I.F.	$2,566,731,077	$3,979,407,139	$3,922,008,723	$4,189,339,202	$5,020,597,071	$7,094,828,881	$9,233,317,906	$8,797,774,083
France (China)		-$597,761,323	-$46,221,436	-$207,467,428	$30,657,788	$1,502,333,803	$2,645,611,108	$3,081,965,850	$3,173,264,344
Chinese Under (-)/Overstatement		-123.3%	-101.2%	-105.3%	-99.3%	-70.1%	-62.7%	-66.6%	-63.9%
Germany	C.I.F.	$5,580,822,928	$6,323,870,966	$4,632,430,943	$3,377,885,492	$3,694,999,866	$7,897,450,437	$15,212,571,742	$17,023,570,062
Germany (China)		-$138,439,819	-$612,312,381	-$3,250,709,547	-$4,230,140,853	-$5,725,655,221	-$4,896,696,043	$3,402,183,729	$4,308,972,411
Chinese Under (-)/Overstatement		-102.5%	-109.7%	-170.2%	-225.2%	-255.0%	-162.0%	-77.6%	-74.7%
Greece	C.I.F.	$507,864,434	$628,100,707	$743,510,798	$864,507,680	$1,251,435,551	$1,603,210,117	$1,913,922,342	$2,009,234,207
Greece (China)		$346,101,886	$533,021,188	$638,378,268	$679,681,057	$1,042,627,734	$1,298,330,983	$1,853,762,390	$2,080,825,325
Chinese Under (-)/Overstatement		-31.9%	-15.1%	-14.1%	-21.4%	-16.7%	-19.0%	-3.1%	3.6%
Hong Kong	C.I.F.	$13,195,186,574	$13,495,922,008	$9,491,703,970	$4,876,883,709	-$2,936,570,823	-$5,717,008,369	-$4,529,498,291	-$5,144,997,160
Hong Kong (China)		$30,368,417,747	$35,570,480,755	$37,550,168,694	$48,234,748,980	$65,741,587,604	$89,914,607,583	$112,884,490,555	$145,179,803,403
Chinese Under (-)/Overstatement		130.1%	163.6%	295.6%	889.0%	2338.7%	1672.8%	2592.2%	2921.8%
Iceland	F.O.B.	$33,200,633	$31,611,892	$49,393,084	$46,329,751	$75,548,308	$112,025,046	$197,478,609	$226,451,754
Iceland (China)		-$831,104	$4,177,387	$16,310,269	$4,792,615	$23,910,105	$20,005,275	$30,229,707	$39,674,648
Chinese Under (-)/Overstatement		-102.5%	-86.8%	-67.0%	-89.7%	-68.4%	-82.1%	-84.7%	-82.5%
Ireland	C.I.F.	$357,293,532	$494,969,153	$304,128,831	$171,463,638	$517,632,739	$733,552,270	$695,338,377	$1,012,021,587
Ireland (China)		$15,686,914	-$22,437,317	-$51,633,401	$115,635,627	$487,820,617	$1,010,976,518	$1,832,511,441	$2,449,295,286
Chinese Under (-)/Overstatement		-95.6%	-104.5%	-117.0%	-32.6%	-5.8%	37.8%	163.5%	142.0%
Italy	C.I.F.	$3,127,614,267	$3,981,521,013	$3,448,493,576	$3,669,998,467	$5,931,112,113	$8,492,439,477	$11,036,150,671	$14,326,068,796
Italy (China)		$378,665,612	$877,854,717	$409,960,254	$723,247,870	$1,835,458,046	$3,109,507,987	$5,107,370,002	$7,800,089,221
Chinese Under (-)/Overstatement		-87.9%	-78.0%	-88.1%	-80.3%	-69.1%	-63.4%	-53.7%	-45.6%
Japan	C.I.F.	$17,528,604,615	$22,010,472,105	$23,964,459,781	$18,786,952,435	$14,326,234,324	$15,752,103,812	$23,216,064,071	$19,793,465,789
Japan (China)		$330,541,627	$2,166,789,877	$4,408,427,744	-$2,331,555,214	-$11,039,881,476	-$15,945,823,509	-$11,346,994,726	-$18,248,419,842
Chinese Under (-)/Overstatement		-98.1%	-90.2%	-81.6%	-112.4%	-177.1%	-201.2%	-148.9%	-192.2%
Luxembourg	C.I.F.	$10,482,376	$15,057,306	$17,036,854	$12,111,666	$1,552,027,604	$2,284,748,602	$2,464,790,466	$3,968,351,887
Luxembourg (China)		-$7,854,555	$10,215,446	-$16,157,779	$3,813,742	$201,624,353	$794,888,323	$1,896,460,578	$1,855,123,917
Chinese Under (-)/Overstatement		-174.9%	-32.2%	-194.8%	-68.5%	-87.0%	-65.2%	-23.1%	-53.3%
Malaysia	C.I.F.	-$286,152,884	$47,122,989	-$206,785,886	$614,414,927	-$34,805,592	$1,439,432,069	$3,214,674,544	$3,368,509,257
Malaysia (China)		-$1,751,450,176	-$2,641,361,442	-$2,671,870,573	-$3,855,267,471	-$7,156,195,533	-$9,168,668,195	-$8,484,788,906	-$8,857,699,685
Chinese Under (-)/Overstatement		512.1%	-5705.3%	1192.1%	-727.5%	20460.5%	-737.0%	-363.9%	-363.1%
Mexico	F.O.B.	$1,794,716,168	$2,676,089,508	$3,745,181,851	$5,760,721,832	$8,937,828,345	$14,006,748,921	$16,496,802,655	$22,753,641,884
Mexico (China)		$640,874,474	$871,347,900	$1,079,341,748	$1,804,972,527	$1,674,648,979	$2,952,297,379	$3,421,340,371	$6,348,478,807
Chinese Under (-)/Overstatement		-64.3%	-67.4%	-71.2%	-68.7%	-81.3%	-78.9%	-79.3%	-72.1%
Netherlands	C.I.F.	$3,821,130,070	$6,323,264,440	$7,611,362,849	$9,338,842,685	$13,826,029,107	$19,662,065,248	$27,180,198,181	$33,098,760,762
Netherlands (China)		$4,454,209,887	$5,509,324,633	$5,909,977,802	$7,575,692,838	$11,660,338,601	$15,700,940,842	$25,868,028,434	$27,377,311,396
Chinese Under (-)/Overstatement		16.6%	-12.9%	-22.4%	-18.9%	-15.7%	-20.1%	-4.8%	-17.3%
New Zealand	V.F.D.	$363,270,317	$389,786,646	$393,488,718	$471,148,003	$763,571,223	$944,453,036	$1,534,004,700	$1,792,999,379
New Zealand (China)		-$114,567,891	-$190,164,383	-$264,548,689	-$166,960,175	-$169,374,115	-$261,517,687	$1,279,514,158	$371,805,275
Chinese Under (-)/Overstatement		-131.5%	-148.8%	-167.2%	-135.4%	-122.2%	-127.7%	-16.6%	-79.3%
Norway	C.I.F.	$355,962,270	$671,598,190	$273,525,104	$261,459,628	$778,356,905	$1,382,837,047	$2,051,083,319	$1,781,749,066
Norway (China)		-$117,129,635	-$93,517,961	-$129,762,238	-$349,963,648	$77,522,620	-$297,175,788	$235,130,113	$512,743,995
Chinese Under (-)/Overstatement		-132.9%	-113.9%	-147.4%	-224.3%	-90.0%	-121.5%	-88.5%	-71.2%
Peru	C.I.F.	$784,062	-$167,491,524	-$90,595,403	-$156,586,572	-$66,707,029	-$505,767,902	-$855,828,479	-$760,884,001
Peru (China)		-$163,491,694	-$387,916,433	-$295,930,682	-$447,933,649	-$368,505,564	-$1,028,486,428	$553,256,927	-$1,719,309,557

Prepared by Georgetown Economic Services

TABLE 10
Chinese Misstatement of Trade Balances, by Trading Partner
Trade Balances AS REPORTED BY 39 PARTNER COUNTRIES AND BY CHINA FOR THE 39 PARTNER COUNTRIES
Annual 1999-2006
All Commodities, FOB Values in US Dollars (*)

:hina Trade Balances

	Valuation as Reported (*)	1999	2000	2001	2002	2003	2004	2005	2006
hinese Under (-)/Overstatement		-20951.9%	131.6%	226.7%	186.1%	452.4%	103.4%	164.6%	126.0%
hilippines	F.O.B.	$465,100,222	$104,394,326	$160,313,527	-$121,691,922	-$345,467,260	$7,148,170	-$1,186,033,984	-$945,046,666
hilippines (China)		$517,930,729	-$129,475,587	-$226,238,800	-$1,013,391,441	-$2,899,589,847	-$4,344,254,597	$2,537,619,130	-$11,054,415,494
hinese Under (-)/Overstatement		11.4%	-224.0%	-241.1%	732.8%	739.3%	-60874.4%	314.0%	1069.7%
ortugal	C.I.F.	$250,880,440	$285,906,898	$245,396,614	$233,654,384	$236,899,110	$424,310,437	$458,715,116	$654,511,841
ortugal (China)		$183,711,294	$216,219,519	$192,630,743	$222,404,907	$221,602,139	$321,395,053	$384,070,432	$1,023,675,033
hinese Under (-)/Overstatement		-26.8%	-24.4%	-21.5%	-4.8%	-6.5%	-24.3%	-16.3%	56.4%
ussia	C.I.F.	-$2,148,650,855	-$2,858,936,560	-$2,444,568,016	-$2,920,271,797	-$3,697,679,370	-$3,807,173,089	-$4,314,896,661	-$1,547,553,361
ussia (China)		-$2,513,384,995	-$3,249,972,280	-$4,846,418,503	-$4,463,515,679	-$3,203,414,480	-$2,413,492,128	$12,933,061,634	-$832,481,314
hinese Under (-)/Overstatement		17.0%	13.7%	98.3%	52.8%	-13.4%	-36.6%	-399.7%	-46.2%
ingapore	C.I.F.	$1,492,825,024	$1,381,192,239	$1,506,317,498	$1,563,237,315	$383,654,991	$5,731,982	-$264,150,426	-$628,255,307
ingapore (China)		$644,705,932	$948,034,465	$908,887,185	$267,137,551	-$1,088,970,258	-$606,354,842	$1,012,056,615	$6,397,232,759
hinese Under (-)/Overstatement		-56.8%	-31.4%	-39.7%	-82.9%	-383.8%	-10678.4%	-483.1%	-1118.3%
outh Africa	F.O.B.	$549,214,901	$651,117,834	$610,620,561	$910,770,363	$1,335,682,739	$2,571,311,858	$3,550,552,418	$4,782,695,310
outh Africa (China)		$43,120,696	$28,281,491	-$62,737,390	$105,998,340	$280,065,864	$144,307,015	$554,419,324	$1,878,258,617
hinese Under (-)/Overstatement		-92.1%	-95.7%	-110.3%	-88.4%	-79.0%	-94.4%	-84.4%	-60.7%
outh Korea	C.I.F.	-$5,666,652,041	-$6,724,000,272	-$5,987,200,887	-$8,007,629,956	-$14,296,044,477	-$21,657,544,946	-$25,199,152,333	-$23,330,337,329
outh Korea (China)		-$8,553,321,339	-$10,760,929,665	-$9,681,556,470	-$11,643,943,538	-$20,897,660,127	-$31,247,814,181	-$37,913,300,715	-$40,769,448,016
hinese Under (-)/Overstatement		50.9%	60.0%	61.7%	45.4%	46.2%	44.3%	50.5%	74.7%
pain	C.I.F.	$2,732,810,215	$3,106,093,071	$3,188,326,676	$3,526,481,900	$4,851,299,578	$7,014,257,936	$9,638,988,264	$12,351,756,174
pain (China)		$1,281,538,921	$1,533,073,456	$1,585,116,766	$1,723,667,861	$2,597,644,291	$3,796,073,727	$6,462,879,635	$8,627,665,347
hinese Under (-)/Overstatement		-53.1%	-50.6%	-50.3%	-51.1%	-46.5%	-45.9%	-33.0%	-30.2%
weden	C.I.F.	-$148,231,085	-$236,190,605	$29,328,150	$263,378,603	$317,419,275	$538,640,260	$1,356,474,937	$1,925,439,728
weden (China)		-$1,434,047,147	-$1,712,867,775	-$1,133,106,327	-$791,899,310	-$1,123,533,367	-$1,308,639,231	-$396,207,745	-$4,583,753
hinese Under (-)/Overstatement		867.4%	625.2%	-3963.5%	-400.7%	-454.0%	-343.0%	-129.2%	-100.2%
witzerland	C.I.F.	$477,090,773	$466,103,711	$283,862,138	$17,249,625	-$128,579,461	-$316,048,983	-$201,700,421	-$298,388,251
witzerland (China)		-$286,122,330	-$640,378,669	-$991,847,582	-$1,296,709,861	-$1,709,059,595	-$1,928,089,493	-$1,743,879,862	-$1,533,678,594
hinese Under (-)/Overstatement		-160.0%	-237.4%	-449.4%	-7617.3%	1229.2%	510.1%	764.5%	414.0%
aiwan	C.I.F.	$1,771,679,678	$1,706,228,776	$875,001,636	-$2,375,696,457	-$10,965,474,816	-$18,158,558,660	-$21,835,432,877	-$24,975,961,733
aiwan (China)		-$14,608,835,517	-$19,182,325,526	-$20,971,250,614	-$29,588,707,255	-$37,882,190,564	-$47,973,786,675	-$54,363,578,490	-$62,044,064,049
hinese Under (-)/Overstatement		-924.6%	-1224.3%	-2496.7%	1145.5%	245.5%	164.2%	149.0%	148.4%
hailand	-	$591,464,170	$404,620,970	$668,986,531	$1,129,935,834	$60,746,467	$678,434,826	$1,485,815,126	$1,162,890,153
hailand (China)		-$1,205,790,598	-$1,917,172,314	-$1,973,575,576	-$2,359,585,763	-$4,558,638,586	-$5,160,350,471	-$5,475,441,095	-$7,300,330,103
hinese Under (-)/Overstatement		-303.9%	-573.8%	-395.0%	-308.8%	-7604.4%	-860.6%	-468.5%	-727.8%
urkey	-	$804,753,334	$1,157,827,787	$663,203,621	$1,060,172,483	$1,976,655,821	$3,841,050,130	$5,980,958,202	$6,781,245,616
urkey (China)		$591,644,438	$957,476,673	$456,764,575	$814,965,455	$1,559,107,749	$2,260,047,718	$3,650,627,129	$6,580,211,430
hinese Under (-)/Overstatement		-26.5%	-17.3%	-31.1%	-23.1%	-21.1%	-41.2%	-39.0%	-3.0%
nited Kingdom	C.I.F.	$8,297,137,526	$10,039,489,684	$10,765,031,352	$12,938,332,078	$15,498,725,516	$19,994,177,684	$24,030,815,039	$28,396,517,190
nited Kingdom (China)		$2,035,947,092	$2,897,619,711	$3,435,130,705	$4,888,645,387	$7,433,667,279	$10,460,029,624	$13,747,409,878	$17,973,834,705
hinese Under (-)/Overstatement		-75.5%	-71.1%	-68.1%	-62.2%	-52.0%	-47.7%	-42.8%	-36.7%
nited States	Customs Value	$68,668,252,218	$83,809,928,735	$83,096,003,240	$103,064,674,758	$124,068,154,039	$161,937,980,742	$201,544,823,965	$232,548,623,317
nited States (China)		$23,502,667,626	$30,895,623,753	$29,425,498,278	$44,092,895,878	$60,321,334,306	$82,553,423,861	$116,640,495,095	$147,255,040,687
hinese Under (-)/Overstatement		-65.8%	-63.1%	-64.6%	-57.2%	-51.4%	-49.0%	-42.1%	-36.7%

OURCE: Global Trade Atlas, Partner Countries and China Customs
) All reported CIF values were converted to FOB values using a 5% CIF/FOB deflator.
ote - Data not adjusted for Hong Kong Re-exports; NA = Not Available, NC = Not Calculable

METHODOLOGICAL EXPLANATION

Explanation of Hong Kong-Adjusted Chinese Export/Import Data

China exports goods through Hong Kong to its partner countries, and imports goods through Hong Kong from its trade partners, in addition to goods traded directly with those partners. Because Hong Kong is included as one of the partner countries in this analysis, that portion of total Hong Kong trade originating from or destined to the Mainland (i.e., the re-export trade) is counted both by Hong Kong and by the destination countries as trade with China. However, even when this double-counting of Chinese exports and imports through Hong Kong is adjusted, China's trade surplus in 2006 is estimated at a significant $464.2 billion with the 39 partner countries, as shown in Table 5D.

The methodology for resolving the double-counting of re-exports by Hong Kong of China-origin and China-destination goods is outlined as follows:

For Chinese imports:

To remove alleged double-counting of Chinese imports,[1] Hong Kong's re-exports **to** China from the world must be subtracted. The double-counting occurs when the partner countries report exports to China that actually arrive in Hong Kong and are then re-exported by Hong Kong to China (and are reported by Hong Kong as exports to China from Hong Kong). China's imports, therefore, are overstated by the re-exports from Hong Kong. In 2006, Hong Kong reported $143.9 billion of re-exports to China from the world.[2] A six-percent discount was applied to these re-exports to account for the estimated re-export mark-up applied in Hong Kong on other countries' goods arriving in Hong Kong but destined for China. For 2006, subtracting the mark-up-adjusted $135.3 billion of Hong Kong's re-exports to China's imports from the world in 2006 results in an adjusted Chinese import total of $476.4 billion (see Table 5D), compared to China's unadjusted import total of $611.7 billion (see Table 3D).

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[1] As Hong Kong data are included with partner-country data, some of the world exports to China are double-counted. According to Bronfenbrenner's 2001 Report to the U.S.-China Security Commission/U.S. Trade Deficit Review Commission, "There is a significant share of U.S. exports to China that are funneled through Hong Kong as re-exports to China (about 42 percent in 1995).... Some of these Hong Kong re-exports originating in the U.S. and bound for China are not identified correctly as U.S. exports to China in U.S. trade data" (Bronfenbrenner, 67). Thus, U.S. and, by extension, *world* exports that are sent via Hong Kong but destined for the Mainland are double-counted because they are reported both in the originating country's export statistics and in Hong Kong's exports statistics to China.

[2] As reported by Hong Kong Statistics and Customs.

For Chinese exports:

To remove alleged double-counting of Chinese exports, Hong Kong's re-export data **from** China to the world must be subtracted. The double-counting occurs when Chinese exports through Hong Kong to other partner countries are counted once by those partner countries as imports from China, but also again by Hong Kong as its own imports from China. In 2006, Hong Kong reported $188.3 billion of re-exports from China to the world.[3] A 25-percent discount was applied to these estimated re-exports to account for the re-export mark-up applied in Hong Kong on China's goods arriving in Hong Kong but destined for the world.[4] For 2006, subtracting the mark-up-adjusted $141.2 billion of Hong Kong's re-exports to the rest of world results in an adjusted Chinese export total of $940.6 billion (see Table 5D), compared to China's unadjusted export total of $1,081.8 billion (see Table 3D).

Calculating China's balance-of-trade using the adjusted data ($940.6 in exports minus $476.4 in imports) results in a Chinese surplus with the 39 partner countries of $464.2 billion in 2006 (see Table 5D).

Explanation of Hong Kong-Adjusted US-China Trade Balances

The U.S. also trades goods through Hong Kong with China in addition to goods traded directly with China. If these Hong Kong trade flows are ignored, then U.S. exports to China (as reported by the United States) and China's exports to the United States (as reported by China) are undercounted (compare Tables 1 and 2). Even when the trade through Hong Kong is adjusted and properly attributed, however, China's trade surplus in 2006 is estimated at a significant $219.2 billion with the United States, as shown in Table 2B. The methodology for correctly accounting for re-exports of goods by Hong Kong is as follows:

For Chinese Exports:

To adjust for the under-counting of Chinese exports to the United States, Hong Kong's re-exports to the United States from China must be added to China's reported exports to the United States. The under-counting occurs when China reports exports to Hong Kong that are then re-exported by Hong Kong to the United States. U.S. Customs usually is able to attribute the actual origin of these re-exported goods to China (rather than to Hong Kong) and records them as such. China's exports, therefore, are understated by the value of Chinese goods re-exported from Hong Kong to the United States. In 2006, Hong Kong reported $40.1 billion in re-exports of Chinese goods to the United States. A 25-percent discount was applied to these re-exports to account for the estimated re-export markup applied in Hong Kong on China 's goods arriving in Hong Kong

[3] As reported by Hong Kong Statistics and Customs.

[4] "A survey of re-export trade carried out by the Hong-Kong Census and Statistics Department showed the average re-export markup on Chinese exports to the United States is about 25 percent.... The 25 percent markup [that] gets paid to Hong Kong middlemen, not to China, inflates the value of Chinese imports in U.S. data" (Bronfenbrenner, 67).

but destined for the United States. For 2006, adding the mark-up adjusted $30.1 billion of Hong Kong's re-exports to the United States results in an adjusted Chinese export total to the United States of $233.6 billion (see Table 2A), compared to China's unadjusted export total to the United States of $203.5 billion (see Table 1A).

For U.S. Exports:

To adjust for the under-counting of U.S. exports to China, Hong Kong's re-exports from the United States to China must be added to the United States' reported exports to China. The under-counting occurs when the United States reports exports to Hong Kong are then re-exported by Hong Kong to China. China Customs usually is able to attribute the actual origin of these re-exported goods to the United States (rather than to Hong Kong) and records them as such. U.S. exports, therefore, are understated by the value of U.S. goods re-exported from Hong Kong to China. In 2006, Hong Kong reported $6.5 billion in re-exports of U.S. goods to China. A 6-percent discount was applied to these re-exports to account for the estimated re-export markup applied in Hong Kong on U.S. goods arriving in Hong Kong but destined for China. For 2006, adding the mark-up adjusted $6.1 billion of Hong Kong's re-exports to China results in an adjusted U.S. export total to China of $57.8 billion (see Table 2B), compared to the United States' unadjusted export total to China of $51.7 billion (see Table 1B).

Calculating China's surplus with the United States using the adjusted data results in a Chinese surplus with the U.S. of $219.2 billion in 2006. See Table 2B.

Explanation of Import Valuation Adjustments

There are several established conventions that countries use to record the value of imports. The most commonly used system, *Cost, Insurance, and Freight Import Value* (C.I.F.) includes the cost of insurance and freight in the value of imported goods. Exports, however, are almost universally reported by a Free-on-Board (F.O.B.) value, which does not include the cost of transporting the goods. When examining trade balances, imports and exports must be valued on the same basis. This requires the cost of shipment and insurance to be deducted from import data that are recorded on a C.I.F. basis.

In this analysis, two measures have been utilized to discount C.I.F.-reported imports to their F.O.B. value. The first method, which is used in practice by the IMF, employs a 10-percent deduction to C.I.F. imports to obtain F.O.B. value.[5]

The second method utilizes US ITC C.I.F./C.V. (Customs Value) ratios for U.S. imports for consumption from Asia. These data illustrate the US ITC's estimate of the markup of imports reported on a C.I.F. basis over their F.O.B., or C.V. value. The average mark-up from

[5] This estimate was obtained from the IMF's *Direction of Trade Statistics Quarterly, June 2003*, Page IX: "... data are first adjusted, to allow for the cost of freight and insurance, by a uniformly applied percentage assumed to be 10 percent of the F.O.B. value of imports."

1999-2002 was calculated to be 4.46 percent.[6] This figure is corroborated by the average differences in the F.O.B. and C.I.F. indices of actual shipment data as reported in numerous anti-dumping cases over the years. Thus, the IMF 10-percent estimate may be too high. For simplicity, the present analysis discounts imports reported on a C.I.F. basis by 5 percent (a round number derived from the US ITC data) and also employs the IMF's 10-percent discount for a more conservative comparison. Either method consistently yields large trade imbalances between China and the world from 1999-2002.

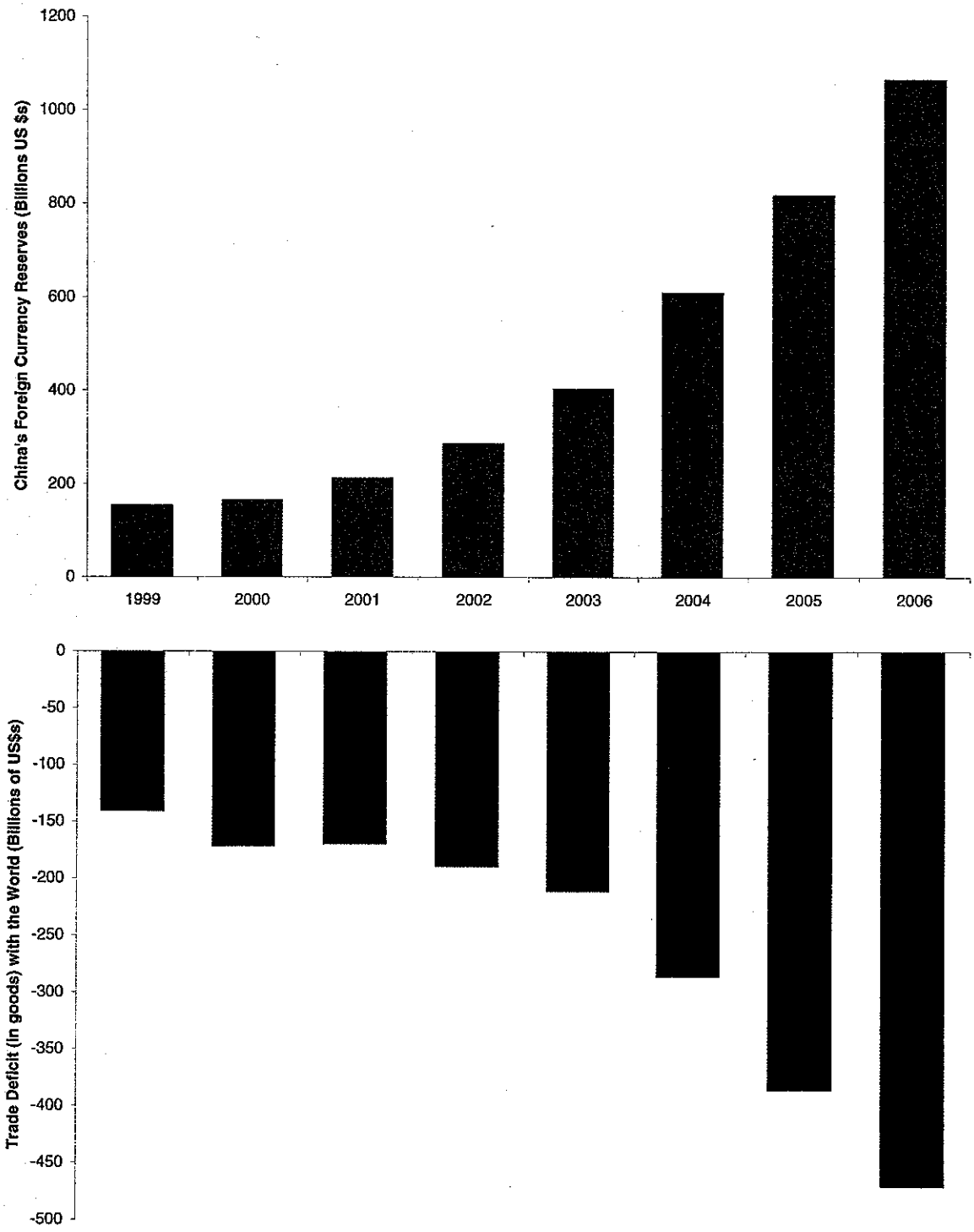
Annual Data on CIF/CV ratios for all import commodities from Asia

COUNTRY	1998	1999	2000	2001	2002	2003
			In Actual Dollars			
China	105.55	107.34	107.56	106.94	106.56	107.15
Hong Kong	103.73	104.41	104.55	104.39	104.78	104.94
India	105.28	105.58	105.81	105.66	105.33	105.37
Indonesia	106.85	108.05	107.97	107.92	107.70	107.88
Japan	102.53	102.61	102.73	102.43	102.56	102.68
Korea	103.61	103.88	103.58	103.72	103.75	103.72
Malaysia	102.67	103.07	103.16	103.22	103.00	102.92
Philippines	103.18	103.66	103.69	103.90	104.04	104.31
Singapore	101.58	101.95	101.91	101.86	102.00	101.84
Taiwan	103.68	104.44	104.39	104.15	104.09	104.50
Thailand	103.99	105.80	106.02	105.71	106.00	106.12
Total—All Asia [last countries not shown]	103.65	104.39	104.52	104.39	104.54	104.91
1999-2002 AVERAGE:	4.46%					

6 *SOURCE: US ITC*

EXHIBIT 4

CHART 1:
The Growing Divergence between China's Foreign Currency Reserves and Partner Country Trade Deficit with China



SOURCE: IMF, International Financial Statistics, GTIS Global Trade Atlas--Data Reported by 39 Partner Countries

Prepared by Georgetown Economic Services

EXHIBIT 5

34 of 72 DOCUMENTS

DATE OF PROMULGATION: 06/22/1998

DATE OF EFFECT: 08/01/1998

SUBJECT: FOREIGN EXCHANGE

PROMULGATOR: STATE ADMINISTRATION OF FOREIGN EXCHANGE

PRCLEG 1131

Detailed Rule for Implementation of Regulation on Management Over the Verification of Export Collection of Foreign Exchange

DETAILED RULE FOR IMPLEMENTATION OF REGULATION ON MANAGEMENT OVER THE VERIFICATION OF EXPORT COLLECTION OF FOREIGN EXCHANGE

(Promulgated by State Administration of Foreign Exchange in Jun. 22 1998)

CONTENTS

CHAPTER 1 GENERAL PROVISIONS

Article 1 This detailed rule is formulated to improve management over the verification of export collection of foreign exchange and prevent drain of exchange in compliance with Regulation on Management over the Verification of Export Collection of Foreign Exchange.

Article 2 State Administration of Foreign Exchange and its local

branches (hereinafter referred to as the SAFE and its branches) are the administrative agencies in charge of the verification of export collection of foreign exchange.

Article 3 When exporting goods abroad, domestic exporting entities should undergo the verification of export collection of foreign exchange.

Article 4 In verification of export collection of foreign exchange, the system of verificating personnel of export collection of exchange is adopted. It is the responsibility of verificating personnel of exporting entity in question to receive verification certificate of export collection of exchange and go through verification of export collection of exchange. Specific rule for the system of verificating personnel shall be drawn up separately by SAFE.

Article 5 The verification of export collection of exchange adhere to the principle of administration by place i. e. exporting entities shall register, receive form and carry out verification at SAFE office in the place where the exporting entity is registered.

CHAPTER 2 MANAGEMENT OF VERIFICATION CERTIFICATE OF EXPORT COLLECTION OF FOREIGN EXCHANGE

Article 6 Verification certificate of export collection of foreign exchange (hereinafter refered to as "verification certificate") is the certificate with uniformed number and validity period. It is prepared and issued by the SAFE and its branches, by which exporting entities can go through export declaration to Customs, export collection of foreign exchange in designated foreign exchange bank, verification of export collection of foreign exchange at the SAFE and its branches, application for tax rebate in taxation bureau. (see appendix 2 for format of verification certificate)

Article 7 Exporting entities shall apply for verification certificate at the SAFE and its branches, which can only used by exporting entities themselves and can't be lent, used falsely, transferred, bought or sold.

Article 8 When applying for verification certificate for the first time, exporting entities shall bring following documents to the SAFE and its branches for registration:

a. Letter of Introduction and application letter of exporting entity;

b. Original text and copy of approval certificate issued by

administration of foreign trade and economy to perform business of export & import;

c. Sidecopy and copy of Business license of Commerce and Industry;

d. Copy of code certificate of legal person of enterprises;

e. Copy of registration certificate of customs;

f. Copy of export contract;

After making sure the verity of all required materials, the SAFE and its branches shall make registration for exporting entities.

Article 9 When applying for verification certificate, exporting entities shall on the spot fill in the column of "exporting entity" the name of the exporting entities or stamp with official seal of the entity. For official use, the verification certificate shall be stamped with official seal of entity.

Article 10 With the help of computer system, the SAFE and its branches determine the amount of verification certificates that exporting entities can receive, issue verification certificates to exporting entities and mark validity period on them.

Article 11 Verification certificate is valid within two months since it is issued. Exporting entities shall return the unused verification certificate to the SAFE for cancellation within one month as of the expiration date.

Article 12 When no longer engaging in export & import business for bankruptcy, stoppage of production, merge and transfer of production, exporting entities shall return the unused verification certificates to the SAFE and its branches for cancellation within one month, and continue to finish the procedures of verification of finished export business according to relevant provisions.

CHAPTER 3 CUSTOMS DECLARATION FOR EXPORT AND RETURN OF STUB

Article 13 When filling verification certificate, exporting entities shall ensure accuracy, completeness and no alteration, and shall conform to the recorded content on the customs declaration form (hereinafter referred to as "declaration form") of exported goods.

Article 14 In the event of forward collection of exchange whose collection date is expected to be over 180 days beyond the customs declaration date, exporting entities shall record at the SAFE and its branches with forward export contract and verification certificate

before customs declaration. Days of the forward period shall be marked in the column of "means of collection" on the verification certificate. If record has not been made at the SAFE and its branches, they shall be regarded as spot export collection of exchange.

Article 15 No matter dealer export or agent export, exporting entities shall use its own verification certificate to make customs declaration for export.

Article 16 Customs shall accept and handle declaration for export based on verification certificate within validity period and stamped with official seal of the exporting entity. Only after no mistakes are found in the examination can customs permit entrance and clearance. After the goods have been shipped out of Chinese territory, customs shall write their opinion in the column of "Check and Release by Customs" and stamp with "proof seal". At the same time Customs shall issue to exporting entities computer-printed declaration certificate with anti-falsification tag and marked with total turnover of transaction and stamped with "proof seal" (Before the computer network is connected between customs and the SAFE, verification certificate must be pasted with anti-falsification tag; after the network has been connected, then it will be pasted with anti-falsification tag no longer). Then exporting entities can go through verification procedures at the SAFE and its branches with this verification certificate.

In the event of goods temporarily exported, such as exhibition articles outside Chinese territory, free maintenance equipment, free sample, free materials for lab experiment, self-use mechanical equipment or tools, office and daily life articles of engineering personnel under the item of contracted engineering project outside Chinese territory, customs shall issue declaration form for verification of export collection of exchange in the course of check and release.

Article 17 In the case that goods are returned for some reason, after having finished its import procedures, customs shall issue a customs import declaration form. The declaration form shall be marked clearly with the return of goods and stamped with "proof seal", then exporting entities shall bring the declaration form to go through cancellation procedures of verification certificate at the SAFE and its branches.

Article 18 Exporting entities shall send the stub of verification

certificate together with commercial invoices and declaration form to the SAFE and its branches within 60 days since the date of customs declaration. If the export business is over US $ 10,000 (including US $ 10,000) and conducted by means of sending documents by itself, corresponding approval documents shall be presented.

When no mistakes are found in the course of examination of documents provided by exporting entities, the SAFE and its branches shall take back the verification certificate and make registration.

CHAPTER 4 EXPORT COLLECTION OF EXCHANGE AND ITS VERIFICATION

Article 19 Document of surrender of exchange only for verification of export collection of exchange and notice of collection for special use in verification of export collection of exchange (the above-mentioned two kinds of certificate are hereinafter referred to as "special copy for verification of export collection of exchange") are important certificate for exporting entities to finish verification of export collection of exchange. In case of exchange earnings of exporting entities, after having determining it is the export proceeds directly from offshore earnings, bank shall go through the procedures of surrender of exchange or the entry of the earning into current account of exchange of exporting entities. Bank shall also provide the special form for verification of export collection of exchange stamped with "Special Combined Seal of Verification of Export Collection of Exchange".

Article 20 the special form for verification of export collection of exchange shall be filled together with reserve copy of bank and account-entry form of beneficiary and shall have following elements:

a. the name of the bank involved;

b. date of surrender of exchange or entering into account;

c. name and account number of collecting entities;

d. amount and kind of currency of collection of exchange;

e. detail, its amount and kind of currency of various deducted expenses;

f. net amount of FX surrender or amount and kind of currency of money entered into account;

g. code number of verification certificate;

h. mark of "Special copy for verification of export collection of exchange";

i. official business seal of bank, "Special Combined Seal of Verification of Export Collection of Exchange";

In case of many exports with only one collection of exchange, bank shall ask exporting entities to provide code numbers of all verification certificates corresponding to the collection. When providing Special copy for verification of export collection of exchange, bank shall fill the code numbers of all verification certificates.

The copy for bank shall be preserved for 5 years for future reference.

Bank shall send format of Special copy for verification of export collection of exchange and the model of Special Combined Seal of Verification of Export Collection of Exchange to the SAFE and its branches for record.

Article 21 Special copy for verification of export collection of exchange provided by bank shall be stamped with "Special Combined Seal of Verification of Export Collection of Exchange" which can only be stamped on Special copy for verification of export collection of exchange and can't be stamped on other copies.

Article 22 In case of exchange earnings of exporting entities, after having determining it is the export proceeds directly from offshore earnings, bank shall differentiate several circumstances and then according to relevant provisions go through procedures of surrender of exchange or the entry of the earning into FX current account of exporting entities. Bank shall also provide special copy for verification of export collection of exchange stamped with "Special Combined Seal of Verification of Export Collection of Exchange":

a. In case of exchange earnings of exporting entities more than US $ 50,000 (including US $ 50,000) and exchange earnings more than US $ 50,000 settled in means of documentary L/C, warranty letter and document collection, bank shall go through the procedures of surrender of exchange or the entry of the earning into account according to the code number of verification certificate provided by exporting entities and provide exporting entities with Special Combined Seal of Verification of Export Collection of Exchange.

b. In case of advance on sales of exporting entities more than US $ 50,000 under the item of export, bank shall go through procedures of surrender of exchange or the entry of the earning into account according

to original verification certificate stamped with "seal of advance payment" by the SAFE and its branches provided by exporting entities. In case of advance on sales by entrusting party under the item of export, entrusting party shall go through procedures of surrender of exchange or the entry of the earning into account according to original verification certificate stamped with "seal of advances on sales" by the SAFE and its branches provided by agent and original text of agency agreement. Bank shall provide exporting entities with Special copy for verification of export collection of exchange.

c. In case of exchange earning is more than US $ 50,000 under the item of means of remittance and the exporting entity belongs to trusted enterprises in aspect of payment of exchange", bank can first go through the procedures of surrender of exchange or the entry into account. But only after the exporting entity has provided corresponding evidential documents of collection and remittance and original verification certificate of the exporting entity stamped with "proof seal" of customs and are checked in transaction-by-transaction way can the bank provide Special copy for verification of export collection of exchange. In case of collection of exchange by entrusting party under the item of agent export and the exporting entity belongs to trusted enterprises in aspect of FX surrender", bank can go through the procedures of FX surrender or the entry of the earning into account according to above-mentioned method together with original text of agent agreement But only after the exporting entity provide corresponding evidential documents of collection and remittance and original verification certificate of the exporting entity stamped with "proof seal" of customs and are checked in transaction-by-transaction way can the bank provide Special copy for verification of export collection of exchange.

In case of exchange earnings more than US $ 50,000 under the item of means of remittance and the exporting entity doesn't belong to "trusted enterprises in aspect of FX surrender", bank shall go through the procedures of FX surrender or the entry into account according to original verification certificate of the exporting entity stamped with "proof seal" of customs. In case of collection of exchange by entrusting party under the item of agent export and the exporting entity doesn't belong to trusted enterprises in aspect of FX surrender", bank shall go

through procedures of FX surrender or the entry into account according to original verification certificate of the exporting entity stamped with "proof seal" of customs. Bank shall provide exporting entities with special copy for verification of export collection of exchange.

d. In case of export collection of exchange settled in cash of foreign currency, bank shall go through the procedures of FX surrender according to Provisional Rule on Control over Collection and Payment in Cash of Foreign Currency by Domestic Entities (Huiguanzi (96) No. 211, at the same time Bank shall provide exporting entities with special document of Verification of Export Collection of Exchange.

e. In case of money of claim settlement derived from export credit insurance and other export insurance of goods, bank shall go through the procedures of FX surrender or the entry into settlement according to original verification form provided by exporting entities. Bank shall provide exporting entities with special copy for verification of export collection of exchange.

Article 23 In case of packing loan or export documentary bill, while going through the procedures of FX surrender or the entry into settlement bank shall not provide special copy for verification of export collection of exchange. Only after having collecting the export loan can the bank go through relevant procedures according to requirements in the Article 22 of this detailed rule and provide special copy for verification of export collection of exchange.

Article 24 When bank provides exporting entities with special copy for verification of export collection of exchange according to requirements in Article 22 of this detailed rule, the number of verification certificate marked shall be the same with those provided by exporting entities. When original verification certificates provided by exporting entities are needed for the providing of special copy for verification of export collection of exchange, the date, amount and kind of currency of payment of exchange and entry into account shall be written in the column of "situation of FX surrender and entry into account by designated foreign exchange bank" on the original verification certificate provided by exporting entities. It shall also be marked with word of "surrender and entry into account" or "payment and entry into account of advance exchange" and shall be stamped with official business

seal of bank.

Article 25 In case of surrender and entry into account of following exchange earnings, bank shall not issue special copy for verification of export collection of exchange:

a. don't belong to exchange earnings derived from export or can't be identified as exchange earnings for the time being;

b. not directly derived from outside Chinese territory;

c. enter into various exchange account other than exchange settlement account;

d. have been entered into various exchange account (including exchange settlement account) and then surrendered or remitted from the account;

e. transferred from other domestic entities or other exchange account of the same entity;

f. other circumstances not conforming to the requirements of Article 22 of this detailed rule.

Article 26 In case of foreign exchange having been provided with special copy for verification of export collection of exchange after surrender of exchange or entry into account, for various reasons the account shall be adjusted or used to reverse an error entry of account, bank shall retrieve the issued special copy for verification of export collection of exchange for destroy.

Article 27 In case of agent collecting exchange under the item of agent export, if agent has exchange settlement account and need to transfer the exchange belonging to entrusting party into the account of entrusting party, then all the collected exchange shall be entered into agent's exchange settlement account. Bank provides agent with special notice of collection for verification of export collection of exchange, then agent shall transfer the exchange according to relevant provisions. If agent doesn't have exchange settlement account, then they should surrender exchange. Bank shall provide agent with special payment document of verification of export collection of exchange and agent then shall remit Renminbi to the account of entrusting party.

Article 28 Exporting entities shall timely collect exchange after having made customs declaration for export. They should collect exchange within 180 days as of the date of customs declaration for spot export. For forward export, they shall collect exchange according to the stipulated

date in the export contract registered at the SAFE and its branches. Exporting entities shall go to the SAFE and its branches to go through verification of export collection of exchange within 30 days since the receiving date of exchange by taking verification certificate and special copy for verification of export collection of exchange issued by bank.

In case of export conducted in other special means of trade, exporting entities shall offer evidential documents according to following provisions. All the materials provided shall be original without any alteration:

A. For export in form of exhibition sale and products abroad, customs declaration form for reentry of exhibition articles shall be provided;

B. In the event of export in form of processing and assemblage with imported materials, customs registration form, contract of exporting entities and approval documents from State Economic and Trade Commission shall be presented and verified as conversion charge.

C. In case of export in form of recovery in kind, approval documents from administration of economic and trade, relevant contract and customs declaration form of import shall be provided. If the amount of recovery exceed the figure stipulated in the contract, it should be treated and verified as ordinary trade.

D. In the event of export in form of barter trade, barter trade contract and customs declaration form of import of barter-in goods shall be provided;

E. In the event of export in form of processing with imported materials, full amount of exchange shall be generally collected. Foreign-funded enterprises, which can't collect full amount of exchange, shall be approved in advance by the SAFE and its branches. In case of payment compensated by receipts, contract, customs declaration form of import and customs registration form shall be provided.

F. In the event of export of mechanical equipment and tools, office and daily life articles of engineering personnel needed in contracted engineering projects abroad, written explanation and contract of labor service shall be provided.

Article 29 The verification procedures under the item of agent export are:

a. agent party shall apply for and receive verification certificate and go through export customs declaration and verification of export collection of exchange; b. If entrusting party is to collect exchange and entrusting party and agent have different local branches of the SAFE, then after receiving exchange, entrusting party shall bring relevant certificate such as original text of agency agreement and special copy for verification of export collection of exchange to local branches of the SAFE to confirm the special copy for verification of export collection of exchange. After determining the certificate provided by entrusting party are proper and sound, the SAFE and its branches shall mark on the back of special copy for verification of export collection of exchange the name of local branches of the SAFE of agent party, the name of institution of the agent party, the amount, kind of currency and date of collection of exchange, then shall stamped with a seal (seal of supervision over collection of exchange) and at the same time enter into standing book. Entrusting party shall pass the special copy for verification of export collection of exchange confirmed by the SAFE and its branches over to agent party which shall in turn go through verification of export collection of exchange in local the SAFE and its branches. Agent party's local the SAFE and its branches shall carry out the verification of export collection of exchange based on the special copy for verification of export collection of exchange confirmed by entrusting party's local the SAFE and its branches and other required documents.

If agent party and entrusting party share same local the SAFE and its branches, agent party shall take original text of agency agreement, special copy for verification of export collection of exchange of entrusting party and other required documents needed for verification to carry out verification of export collection of exchange.

c. If agent party is to collect exchange, then agent party can take special copy for verification of export collection of exchange and other documents required for verification directly to local bureau of exchange to finish verification procedures.

Article 30 Exporting entities shall collect full amount of exchange by the total value of transaction on the declaration form. If the discrepancy is over US $ 500, then they shall provide valid documents to

the SAFE and its branches and make explanation.

Article 31 If under the item of export the return and compensation occur, the SAFE and its branches shall examine the bona fide nature of the exchange returned and compensated to exporting entities. After offsetting from the performance of verification of export collection of exchange, they shall issue "certificate of offset verification of export collection of exchange". Bank shall sell FX and make payments upon this certificate.

If verification procedures have been carried out, exporting entities shall also provide certificate of no tax refunded or certificate of paying an over due tax issued by tax bureau when applying for "certificate of offset verification of export collection of exchange".

CHAPTER 5 MANAGEMENT OF SPECIAL FORM FOR EXPORT TAX REFUND

Article 32 After having carried out verification for exporting entities, the SAFE and its branches shall mark on the special form of export tax refund net amount and kind of currency and date of collection of exchange and stamp it with "seal of cancellation" which shall then be returned back to exporting entities.

Article 33 The SAFE and its branches shall provided electrical data verificated in last month within first 5 workdays of every month to local taxation bureau according to requirements of Meeting Summary of Strengthening Management of Export Tax Refund through Electrical Data on Verification of Export Collection of Exchange ((93) Huiguanzi No. 57 of State Administration of Foreign Exchange and General Administration of Taxation.

CHAPTER 6 LOSS AND REISSUE OF VERIFICATION DOCUMENTS

Article 34 If exporting entities lost verification certificate, they shall make a written explanation to the SAFE and its branches and report of the loss within 15 days. After examination and check by the SAFE and its branches, the SAFE and its branches will publish invalidity announcement on newspaper (corresponding fees shall be born by entities losing the verification certificate). And it shall be treated as follows:

a. In case of blank verification certificate, shall be cancelled;

b. In case of verification certificate which has been used in customs declaration of export but hasn't gone through verification of export

collection of exchange, verification of export collection of exchange shall be carried out according to provisions of chapter 4 of this rule and issue "certificate of reissued tax rebate form of verification certificate of export collection of exchange".

c. If verification certificate has been used to carry out verification of export collection of exchange, generally they can't be reissued. In special circumstances export tax refund form is demanded to be reissued, exporting entities shall file application to the SAFE and its branches by certificate of no export tax refunded issued by taxation bureau. Only after receiving approval from the SAFE and its branches can certificate of reissued tax rebate form of verification certificate of export collection of exchange" be issued.

Article 35 If exporting entities lost declaration form, they shall file application for reissue by certificate of not-yet-verified issued by the SAFE and its branches.

Article 36 If exporting entities lost special form for verification of export collection of exchange, they shall first make application for reissue to the SAFE and its branches. After the SAFE and its branches have examined and agreed, they can issue approval document for reissue of special copy for verification of export collection of exchange to exporting entities in 3 months as of receipt of the application. Bank shall reissue the special copy for verification of export collection of exchange for exporting entities upon the presence of the approval document in question and mark the quota of "reissue" on the reissued special copy for verification of export collection of exchange. Without approval from the SAFE and its branches, bank can't presumptuously reissue special copy for verification of export collection of exchange for exporting entities without authorization.

CHAPTER 7 PUNISHMENTS

Article 37 If bank commit following behaviors, the SAFE and its branches shall issue warning, circulate public reprimand and confiscate illegal gains and impose fine ranging from 50,000 to 300,000:

a. provide exporting entities with special copy for verification of export collection of exchange not in compliance with relevant provisions;

b. in case of the elements not fully completed and satisfied, provide

exporting entities with special copy for verification of export collection of exchange;

c. provide same special copy for verification of export collection of exchange more than once;

d. do not carry out settlement according to relevant provisions and result in that exporting entities do not collect exchange beyond the due day;

e. don't observe provisions of Article 24 of this rule to write on the original verification certificate the date and amount of surrender of exchange or entry into account and mark quota of "surrender of exchange or entry into account of remittance" or "payment of exchange or entry into account of advance in sales";

f. Other violations of provisions of this rule;

Article 38 If bank commit following behaviors, the SAFE and its branches shall issue warning, circulate public reprimand, confiscate illegal gains and impose fine ranging from 50,000 to 300,000:

a. lend, falsely use, transfer, sell or buy verification certificate;

b. alter and forge such verification documents as verification form, declaration form, special copy for verification of export collection of exchange;

c. false report of the loss of verification;

d. repeated use of special copy for verification of export collection of exchange issued by bank;

e. cheat of verification using other exchange earnings (for instance non-trade exchange earnings and exchange earnings under capital account)

Article 39 If exporting entities commit following behaviors, the SAFE and its branches shall issue warning, circulate republic reprimand, confiscate illegal gains and impose fine ranging from 10,000 to 30,000:

a. do not turn in the stub of verification certificate to the SAFE within 4 months as of receipt of the form;

b. under the item of spot export, do not collect exchange in 180 days since the date of customs declaration or do not carry out verification within 30 days since collection of exchange without the approval from the SAFE. Under the item of forward export, do not carry out verification within 30 days as of the expected date of collection at the SAFE.

c. the discrepancy of verification of export collection of exchange exceed over 10% of total value of transaction without any proper and sound reasons;

d. in case of loss of verification certificate, do not report the loss to the SAFE within 15 days as of the loss date;

e. unused verification certificates haven't been returned to the SAFE within one month as of the expiration date;

f. loss verification many times and constitute a serious offense;

g. having stopped export business because of bankruptcy, stoppage, merge and transfer, haven't return all the unused verification certificates to the SAFE on time for cancellation and destroy;

h. Other violations of provisions in this rule;

CHAPTER 8 SUPPLEMENTARY PROVISIONS

Article 40 The interpretation of this detailed rule for implementation rests with the State Administration of Foreign Exchange.

Article 41 This Detailed Rule for Implementation shall come into effect as of Aug. 1 1998 and the Detailed Rule for Implementation of Regulation on Management over Verification of Export Collection of Exchange enacted in Dec. 21 1990 and relevant documents (see Appendix V) shall be repealed at the same time.

DATE OF PROMULGATION: 05/19/2000

DATE OF EFFECT: 05/19/2000

SUBJECT: FOREIGN EXCHANGE/TAXATION

PROMULGATOR: STATE BUREAU OF TAXATION/STATE ADMINISTRATION OF FOREIGN EXCHANGE

PRCLEG 2329

Circular on Relevant Issues Concerning Submitting Tax Certificates for Sales of and Payment in Foreign Exchange Related to Non-trade and Certain Capital Account transactions

Circular on Relevant Issues Concerning Submitting Tax Certificates for Sales of and Payment in Foreign Exchange Related to Non-trade and Certain Capital Account transactions

(Promulgated by State Administration of Foreign Exchange and State Administration of Taxation on May 19, 2000)

Guoshuifa (2000) No. 66

Each branch of the State Administration of Foreign Exchange (SAFE), Beijing and Chongqing Foreign Exchange Administration Department,

Examination and assessment of export receipts of foreign exchange in 1999 in line with Provisional Regulations on Examination of Export Receipts of Foreign Exchange was accomplished at the end of March 2000. We hereby circulate the result of the examination and assessment.

Detailed Rewarding and Punishment Rules of Provisional Regulations on Examination of Export Receipts of Foreign Exchange (hereinafter as the "Detailed Rules" in breif) has been jointly issued by the People's Bank of China, Ministry of Foreign Trade and Economic Cooperation (Moftec), and State Administration of Taxation in accordance with Provisional Regulations on Examination of Export Receipts of Foreign Exchange. We will reward "1999-honorable enterprises for collection of export receipts" and punish "1999-high-risky enterprises for collection of export receipts" according to the result of examination and assessment, and to the "Detailed Rules". We hereby make notice on relevant issues concerning implementing the "Detailed Rules" as follows:

1. The People's Bank of China, SAFE, Moftec, and State Administration of Taxation will stipulate rewarding and punishment measures respectively to "1999-honorable enterprises for collection of export receipts" and "1999-high-risky enterprises for collection of export receipts" in the fields of lending rates, foreign exchange administration, foreign trade development fund, and export tax-refund. Each branch shall coordinate with relevant departments when implement rewarding and punishment measures of foreign exchange administration.

2. "Honorable enterprises for collection of export receipts" are exempted from surrendering bond for repatriation of profits resulting from their overseas investment with the approval of SAFE. The deadline of repatriating profits could be extended with the approval of SAFE.

3. SAFE branch could raise the balance ceiling of the foreign exchange settlement account of Chinese-funded "honorable enterprises for collection of export receipts" from 15 percent to 30 percent of their annual foreign trade

volume if they apply to do so. Other key elements of accounts, including the scope of deposits and withdrawals, the method concerning the sale of foreign exchange are completely the same. Balance ceiling the account is fixed in the first quarter of each year according to the foreign trade volume of enterprise in the previous year. When applying to adjust the balance ceiling of their foreign exchange settlement account with SAFE, "honorable enterprises for collection of export receipts" shall submit relevant documents prescribed in Operational Procedures for Maintaining Certain Amount of Foreign Exchange Receipts. SAFE shall fix the balance ceiling of the enterprises' foreign exchange settlement account after verifying submitted documents by comparing their foreign trade volume in the previous year with the dada provided by Moftec, and confirm the ceiling by affixing a seal to "the Application Form for Fixing Balance Ceiling of Foreign Exchange Settlement Account". Supervision over foreign exchange settlement accounts of Chinese-funded "honorable enterprises for collection of export receipts" shall be conducted still according to Circular on Permitting Chinese-funded Enterprises to Maintain Certain Amount of Their Foreign Exchange Receipts and Operational Procedures for Maintaining Certain Amount of Foreign Exchange Receipts.

4. SAFE shall transmit the detailed name list provided by the Moftec of large export enterprises whose exports were more than USD200 million in the previous on to relevant SAFE branches. The relevant branches are required to publish the listed enterprises as "honorable enterprises for collection of export receipts" and grant them corresponding reward if the ratio of their export receipts is not lower than 85 percent and the ratio of their surrendered verification forms of export receipt is not lower than 80 percent.

5. Moftec and its branches shall suspend its foreign trade right if the enterprise is assessed as "high-risky enterprises for collection of export receipts" for one year or as "risky enterprises for collection of export receipts" for two successive year. Each branch is required to make written notice of the assessment result in this year to "risky enterprises for collection of export receipts".

6. The assessment result for the year of 1999 is valid from April 1, 2000 through March 31, 2001.

12/15/03

PRCLEG 526

40 of 72 DOCUMENTS

DATE OF PROMULGATION: 06/20/1996

DATE OF EFFECT: 07/01/1996

SUBJECT: FOREIGN EXCHANGE

PROMULGATOR: PEOPLE'S BANK OF CHINA

PRCLEG 526

Regulations on the Sale and Purchase of and Payment In Foreign Exchange (1996)

REGULATIONS ON THE SALE AND PURCHASE OF AND PAYMENT IN FOREIGN EXCHANGE

(Issued by the People's Bank of China on June 20, 1996)

CONTENTS

CHAPTER ONE GENERAL PROVISIONS

Article 1 These Regulations are formulated with a view to achieving convertibility of the Renminbi for current account transactions through the introduction of a set of rules governing the sale and purchase of and payment in, foreign exchange.

Article 2 Banks involved in foreign exchange business shall comply with these Regulations in conducting businesses related to the sale and purchase of foreign exchange, opening foreign exchange accounts and making external payments all within the business scope duly authorized by the People's Bank of China and the State Administration of Exchange Control.

Article 3 Domestic entities shall promptly repatriate all foreign exchange from abroad unless otherwise authorized by the government.

Article 4 Domestic entities, resident individuals, foreign establishments in China and foreign nationals shall comply with these Regulations with respect to the sale and purchase of foreign exchange, opening foreign exchange accounts and making external payments.

Article 5 When receiving foreign exchange and making external payments in foreign exchange through banks involved in foreign exchange business, domestic entities and resident individuals are obliged to report on balance of payments statistics in accordance with the Regulations on Reporting Balance of Payments Statistics and other relevant regulations as well.

CHAPTER TWO THE SALE AND PURCHASE OF AND PAYMENT IN FOREIGN EXCHANGE FOR CURRENT ACCOUNT TRANSACTIONS

Article 6 Except as provided in Article 7, 8 and 10 of these Regulations with respect to the coverage and quantity for foreign exchange settlement, all the following foreign exchange receipts for domestic entities shall be sold to designated foreign exchange banks in full:

1. Export proceeds for goods in foreign exchange or foreign exchange income generated from entrepot business characterized by an initial payment and subsequent reimbursement and other types of transactions, among which export proceeds in foreign exchange settled under a documentary letter of credit/payment guarantee and documentary collection shall be sold to designated foreign exchange banks upon the presentation of valid commercial documents, and export proceeds for goods in foreign exchange settled by remittance shall be sold to designated foreign exchange banks upon the presentation of the Verification Certificate for Export Proceeds;

2. Foreign exchange earned by successful international competitive bidding for contracts funded by overseas loans;

3. Foreign exchange earned from domestic duty-free shops administered by the customs authorities;

4. Foreign exchange earned by provision of goods or services in connection with transportation (inclusive of all means of transportation), ports (inclusive of airports) and postal and telecommunication services (exclusive of international remittances),

advertisement, consulting, exhibition, consignment, repairs and maintenance, etc, and other agency services;

5. All types of administrative fees, fines and confiscation in foreign exchange collected by administrative and judicial agencies;

6. Foreign exchange received for the transfer of intangible assets such as land use right, copyright, trademark, patent, non-patent technologies and good will; in case that these intangible assets belong to an individual, the sale of foreign exchange is optional;

7. Profits in foreign exchange repatriated by enterprises with direct investment abroad, foreign exchange earnings generated from foreign economic aid programs and other types of foreign exchange income derived from overseas assets;

8. Compensation for claims abroad and refund for security deposit in foreign exchange;

9. Foreign exchange income generated from property rentals and other types of foreign assets;

10. Foreign exchange income from insurance companies for writing insurance policies denominated in foreign currency;

11. Net foreign exchange income from financial institutions duly authorized under the License for Foreign Exchange Business;

12. Foreign exchange from overseas grants, sponsorships and aid programs; and

13. Other types of foreign exchange that shall be sold to designated foreign exchange banks in accordance with regulations of the State Administration of Exchange Control.

Article 7 Domestic entities (exclusive of foreign-funded enterprises) may apply to the State Administration of Exchange Control or its local branches (hereinafter referred to as the SAEC for both) for the permission to open foreign exchange accounts with banks involved in foreign exchange business and shall sell to the banks the following types of foreign exchange in accordance with the relevant regulations:

1. Foreign exchange received in the course of normal business operations by companies undertaking contracts, providing labour, engaging in technical co-operation projects and offering other services abroad;

2. Foreign exchange collected for payments on the part of those businesses that act as an agent for international transactions;

3. Foreign exchange under suspense account, including overseas security deposit for tender bond, performance bond, receipts for later disbursements under entrepot trade; international foreign exchange remittances performed by post and telecommunication services; advance payments in foreign exchange received by Class A travel agencies from foreign travel agencies; foreign exchange received by railway carriers for providing insured overseas transportation; foreign exchange security deposit and collateral received by the customs authorities;

4. Insurance premiums in foreign exchange received by insurance companies for providing insurance and reinsurance abroad and insurance premiums in foreign exchange pending settlement.

The foregoing net foreign exchange income shall be sold in full to designated foreign exchange banks within the prescribed time limit.

Article 8 Foreign exchange earmarked for external payments for grants, sponsorships and payments under aid agreement can be retained subject to the approval of the SAEC.

Article 9 The following types of foreign exchange can be retained:

1. Foreign exchange held by foreign embassies and consulates, resident offices of international organizations and other foreign legal persons; and

2. Personal holdings of foreign exchange by residents and visitors from abroad.

Article 10 Foreign-funded enterprises may retain their foreign earnings derived from current account transactions below the ceiling prescribed by the SAEC and any excess amount shall be sold to designated foreign exchange bank or sold in foreign exchange swap centres.

Article 11 The sale of any foreign currency in cash for an equivalent amount exceeding US$10,000 shall require the customer to present to the designated foreign exchange bank his valid identification card and documents certifying the source of the foreign currency in question before the bank proceeds with the transaction and then files it for the records of the SAEC.

Article 12 Based on the permission to open foreign exchange accounts under Article 7, 8, 9 and 10 of these Regulations, domestic entities, foreign establishments in China and visitors from abroad may open such accounts at banks involved in foreign exchange business in accordance

with the relevant regulations governing the operations of foreign exchange accounts.

Article 13 Domestic entities may make external payments from their own foreign exchange accounts or with the purchased foreign exchange at designated foreign exchange banks for trade and non-trade related operational expenses upon the presentation of valid commercial documents consummate with the payment method as well as other valid commercial documents listed as following:

1. For the import of goods under a documentary letter of credit/payment guarantee, in case of the purchase of foreign exchange for opening a letter of credit, the import contract, Verification Certificate for Foreign Exchange Payments for Imports and the application for opening L/C shall be presented; and in case of the purchase of foreign exchange for payments, valid commercial documents under the letter of credit for payments shall also be provided. The ensuing verification of imports shall require the presentation of the original form for customs declaration for the imported goods;

2. For the import of goods under document collection, the import contract, the Verification Certificate for the Foreign Exchange Payment of Imports, the payment instrument for imports and other valid commercial documents under documentary collection shall be presented. The ensuing verification of imports shall require the presentation of the original form for customs declaration for the imported goods;

3. For the import of goods under remittance payment, the import contract, the Verification Certificate for the Foreign Exchange Payment of Imports, the invoices, the original form for customs declaration for the imported goods, the original transportation documents shall be presented; and in case of any discrepancy between the name of the beneficiary on the bill of lading and the business on the customs declaration form and the name of the buyer on the import contract, and agency agreement between these two parties shall be presented;

4. For an advance payment not exceeding 15 per cent of the total contract value or exceeding 15 per cent but in an amount of less than an equivalent of US100,000, the import contract and the Verification Certificate for the Foreign Exchange Payment of Imports shall be presented. For the import of such goods among the foregoing four types

of imports subject to import quota or import control given their special nature, the import permit issued by the relevant government agency or the import certificate shall be presented; for the import of goods under the automatic registration system, a completed form of registration shall also be presented;

5. For transportation and insurance expenses for imports, the import contract and the original receipts for transportation and insurance charge shall be presented;

6. For implicit commissions not exceeding 2 per cent of the total contract value and explicit commissions of 5 per cent or any other amount above the foregoing percentage but below an equivalent of US$10,000, the import contract or commissions agreement, foreign exchange sale receipt or notice of payment shall be presented; as far as transportation and insurance expenses for export are concerned, the export contract, the original receipts for transportation and insurance charge shall be presented;

7. For the residual payment for imports, the import contract, Verification Certificate for the Foreign Exchange Payment of Imports and Quality Inspection Certificate shall be presented;

8. For other subordinate charges, such as charges for the provision of written materials, technical know-how and information, the import or export contract, Verification Certificate for the Foreign Exchange Payment of Imports, Verification Certificate for Export Proceeds, invoices or receipts for these charges or notes of explanation signed by managers from the import and export businesses shall be presented;

9. For purchase of goods from bonded areas and bonded warehouses and purchase of imported exhibits, valid documents specified in Section 1 to 8 and valid commercial documents shall be presented;

10. For import of intangible assets such as patents, copyrights, trademarks, computer software, etc, the import contract or agreement shall be presented;

11. For refund and compensation related to exports, the foreign exchange sale receipt or notice for payment, claim form, claim settlement certificate and verification certificate indicating the reduced export proceeds shall be presented; and

12. For security deposit required by tender bond for overseas contracts,

tender documents shall be presented; and for performance bond and advance funding for projects, contracts shall be presented.

Article 14 For the following types of external payment to be made by domestic entities for trade and non-trade related commercial purposes, the payment in foreign exchange can be made from the customers' foreign exchange accounts or with the purchased foreign exchange at banks involved in foreign exchange business upon the presentation the payment list and such transaction is subject to ex-post verification:

1. Payments for duty-free imports made by businesses duly authorized by the State Council to sell duty free goods within the prescribed business scope;

2. Payments made by airline, ocean freight, railway departments (businesses) for charges related to international transportation, equipment maintenance, port facilities, fuels, insurance, non-financial leasing and others;

3. Food and other types of allowance paid by airline, ocean freight and railway transportation departments (businesses) to their crew for international service; and

4. Post and telecommunication expenses incurred abroad by post and telecommunication departments.

Article 15 The following types of external payment can be made from their own foreign exchange account of the domestic entities or from the purchased foreign exchange at designated foreign exchange banks after the verification of the bona fide nature of the transaction by the SAEC:

1. Advance payments for goods exceeding the prescribed percentage and amount as stipulated in Section 13.4;

2. Commissions exceeding the prescribed percentage and amount as stipulated in Section 13.6;

3. External payments under entrepot characterized by an initial payment with later reimbursement;

4. Interest payment for external debt; and

5. Cash withdraw exceeding an equivalent of US$10,000.

Article 16 Interest payment by domestic entities for loans in foreign currency extended by domestic financial institutions can be made from their own foreign exchange accounts or with the purchased foreign exchange at designated foreign exchange banks upon the presentation of

the Foreign Exchange Loan (on-lending) Registration Certificate, loan agreement and interest payment notice.

Article 17 The provision of foreign exchange for the budgetary agencies, institutions and social organizations for non-trade and non-commercial activities shall proceed in accordance with the Provisional Regulations on the Provision of Foreign Exchange for Non-trade and Non-Commercial Activities.

Article 18 The provision of foreign exchange for extra-budgetary domestic entities can be made from their own foreign exchange accounts or with the purchased foreign exchange at designated foreign exchange banks upon the presentation of the following documents:

1. For expenses involved covering exhibitions, trade and investment promotion programs, training programs, film and television programs abroad, relevant contracts, the notice of payments from abroad and the approval of the government department in charge shall be presented;

2. For expenses involved covering promotion programme abroad, foreign aid, grants, membership dues to international organizations, registration fees for international conferences, the approval of the government department in charge and other relevant documents shall be presented;

3. For expenses involved covering the start-up fees and annual budget for establishing overseas representative offices, the approval of the government department in charge for such establishment and the proposed budget shall be presented;

4. For examination fees paid abroad by the foreign examination co-ordination centers under the State Education Commission, the contract with foreign counterparts and the statement from foreign institutions offering such examinations as well as the settlement notice shall be presented;

5. For expenses involved in arranging for trade mark, copy right registration, application for patent and other legal or consulting services, the contract and invoices shall be presented; and

6. For traveling expenses on business trips abroad, the travel approval issued by the duly authorized government department shall be presented.

The provision of foreign exchange for such non-commercial activities listed in Section 1 to 6 can be made from the customers' foreign

exchange accounts or with the purchased foreign exchange at designated foreign exchange banks after the verification of the bona fide nature of the transaction by the SAEC.

Article 19 The provision of foreign exchange for personal travel abroad shall proceed in accordance with the Regulations on the Provision of Foreign Exchange for Personal Travel Abroad and the Regulations on Foreign Exchange Remittances by Residents in China.

Article 20 The following types of legitimate income for resident individuals who migrate abroad can be sent abroad with the purchased foreign exchange at designated foreign exchange banks duly authorized by the SAEC upon the presentation of their identification cards and valid documents listed as following:

1. For interest on deposit in Renminbi, the statement for interest on deposit in Renminbi shall be presented;

2. For rental income from property, the rent agreement and statement issued by the property rent agencies shall be presented; and

3. For income generated from other assets, the relevant documents and income statement shall be presented.

Article 21 For repatriation of profits and dividends after tax by the foreign counterpart in an foreign-funded enterprise, the payment can be made from their own foreign exchange accounts or with the purchased foreign exchange at designated foreign exchange banks upon the presentation of the proposal for the profit distribution adopted by the board of directors. For remittance of salary in Renminbi after tax by foreign, overseas Chinese employees and those from Hong Kong, Macao and Taiwan, the payment can be made with the purchased foreign exchange at designated foreign exchange banks upon the presentation of certifying documents.

Article 22 For dividends to be paid in foreign currencies based on the relevant regulations, the payment can be made from the customers' own foreign exchange accounts or with the purchased foreign exchange at designated foreign exchange banks upon the presentation of the proposal for the profit distribution adopted by the board of directors after taxes are paid.

Article 23 For remittance of legitimate income in Renminbi by foreign establishments in China and foreign nationals, the payment can be made

at designated foreign exchange banks duly authorized by the SAEC upon the presentation of certifying documents and the statement for fees and charges collected.

Article 24 For remittance of sale proceeds in Renminbi by foreign establishments in China and foreign nationals for personal effects, equipment and utensils, etc, that they brought in from abroad or purchased in China, the payment can be made at designated foreign exchange banks duly authorized by the SAEC upon the presentation of the registration card issued by the State Business Administration or personal identification cards and the certificate for such sale.

Article 25 Foreign nationals in China, overseas Chinese and Chinese compatriots of Hong Kong, Macao and Taiwan may, prior to their exit, exchange back the unused portion of Renminbi balances upon presentation of their passports and the original exchange receipts (valid for six months after the transaction).

CHAPTER THREE THE SALE AND PURCHASE OF AND PAYMENT IN FOREIGN EXCHANGE CAPITAL ACCOUNT TRANSACTIONS

Article 26 Domestic entities shall open up foreign exchange accounts for capital account transactions at banks involved in foreign exchange business.

Article 27 The following types of foreign exchange belonging to domestic entities can not be sold to designated foreign exchange banks without prior approval of the SAEC:

1. Foreign exchange brought in by overseas legal persons or natural persons for direct investment in China;
2. Foreign exchange proceeds from overseas loans and the issue of bonds or shares denominated in foreign currency; and
3. Other types of foreign exchange derived from capital account transactions duly approved by the SAEC.

Except export proceeds under collection, loan proceeds in foreign currency collected in China and international commercial loans raised by Chinese and foreign joint ventures can not be sold to designated foreign exchange banks.

Article 28 Foreign exchange proceeds from the sale of property or other assets by domestic entities to people abroad can be sold to designated foreign exchange banks for any amount exceeding the ceiling provided in

Article 10.

Article 29 For repayment of loan principal in foreign exchange by domestic entities to Chinese financial institutions in China, the payment can be made from the customers' own foreign exchange accounts or with the purchased foreign exchange at designated foreign exchange banks upon the presentation of the Foreign Exchange Loan (on-lending) Registration Certificate, loan agreement and notice for repayment issued by the creditor.

Article 30 Domestic entities may apply to the SAEC for foreign exchange for the following capital account transactions upon the presentation of the following required documents and the payment can be made from their own foreign exchange accounts or with the purchased foreign exchange at designated foreign exchange banks based on the approval of the SAEC:

1. For repayment of principal of foreign debt, the registration certificate for foreign debt, loan agreement and notice for principal repayment issued by the creditor;.

2. For external guarantee, the contract for guarantee, Registration Certificate for Guarantee in Foreign Exchange and payment notice issued by overseas entities shall be presented;

3. For remittance of investment fund abroad, the approval issued by the government department in charge and investment contract shall be presented; and

4. For authorized capital input in foreign exchange contributed by Chinese counterparts in the foreign-funded business, the approval of the government department in charge and the contract shall be presented.

Article 31 For the increase, transfer and other forms of disposal of capital in foreign exchange by the foreign-funded business, the decision made by the board of directors shall be presented to the SAEC for approval and then the payment can be made from their own foreign exchange accounts or with the purchased foreign exchange at designated foreign exchange banks upon the presentation of the notice for purchase of foreign exchange issued by the SAEC:

The investment of capital in foreign exchange in China by the foreign-funded investment companies and the use of retained earnings by foreign counterparts for capital replenishment or reinvestment shall proceed upon the approval issued by the SAEC.

CHAPTER FOUR SUPERVISION ON THE SALE AND PURCHASE OF AND PAYMENT IN FOREIGN EXCHANGE

Article 32 Foreign-funded businesses may sell or purchase foreign exchange at designated foreign exchange banks or in foreign exchange swap centres; other domestic entities, resident individuals, foreign establishments in China and visitors from abroad can only sell or purchase foreign exchange at designated foreign exchange banks.

Article 33 Before making external payment from customers' own foreign exchange accounts, banks involved in foreign exchange business shall verify the transaction in accordance with the appropriate use for the given foreign exchange accounts and the provisions of Chapter Two and Three of these Regulations.

Article 34 Having completed a transaction for the sale or purchase of foreign exchange, designated foreign exchange banks shall stamp the valid corresponding documents as well various commercial documents and file all these documents for records.

Article 35 Designated foreign exchange banks shall quote the buying and selling rate to banks' customers on the basis of middle exchange rate for Renminbi announced by the People's Bank of China every day and within the prescribed margin for exchange service.

Article 36 The payment from customers' own foreign exchange accounts or with the purchased foreign exchange shall proceed on such a date provided by the settlement method or the relevant contract and earlier payment is prohibited; Advance purchase of foreign exchange is also prohibited except for debt servicing or opening a letter of credit/placing security deposit for payment guarantee.

Article 37 With a view to reducing exchange rate risk related to future payments or debt servicing for customers, designated foreign exchange banks may arrange for forward contracts between Renminbi and foreign currencies or provide other types of hedging services.

Article 38 The payment for the import of goods under barter trade can not be made with the purchased foreign exchange or from customers' own foreign exchange accounts unless otherwise approved by the SAEC.

Article 39 Banks involved in foreign exchange business are obliged to send to the SAEC reports on the sale and purchase of and payment in foreign exchange. Designated foreign exchange banks shall formulate an

internal monitoring system for the sale and purchase of foreign exchange and promptly report to the local branches of the State Administration of Exchange Control in case of any unusual circumstances.

Article 40 Domestic entities shall open foreign exchange accounts at the banks involved in foreign exchange business of their choice in the place of their incorporation and proceed with the sale and purchase of and payment in foreign exchange in accordance with these Regulations. Domestic entities shall need the approval of the SAEC for opening foreign exchange accounts in other places outside the place of their incorporation or abroad. For foreign exchange derived from current account transactions for foreign-funded enterprises, they may open foreign exchange settlement accounts at the banks involved in foreign exchange business at their own discretion in their place of incorporation subject to approval.

Article 41 Banks involved in foreign exchange business and other domestic entities involved in the sale and purchase of and payment in foreign exchange are subject to the unconditional supervision and inspection of the SAEC and shall present or submit all documents when necessary. In case of violation of these Regulations, the SAEC may issue a warning, confiscate illegal income and impose a fine; in case of serious violation, the SAEC may order banks involved in foreign exchange business in question to suspend their business for the sale and purchase of foreign exchange.

CHAPTER FIVE SUPPLEMENTARY PROVISIONS

Article 42 The power of interpretation for these Regulations rests with the State Administration of Exchange Control.

Article 43 These Regulations shall come into effect July 1, 1996. The Provisional Regulations on the Sale and Purchase of and Payment in Foreign Exchange issued on March 26, 1994 shall be repealed. In case of any contradiction with rules and regulations issued prior to these Regulations, the latter shall prevail.

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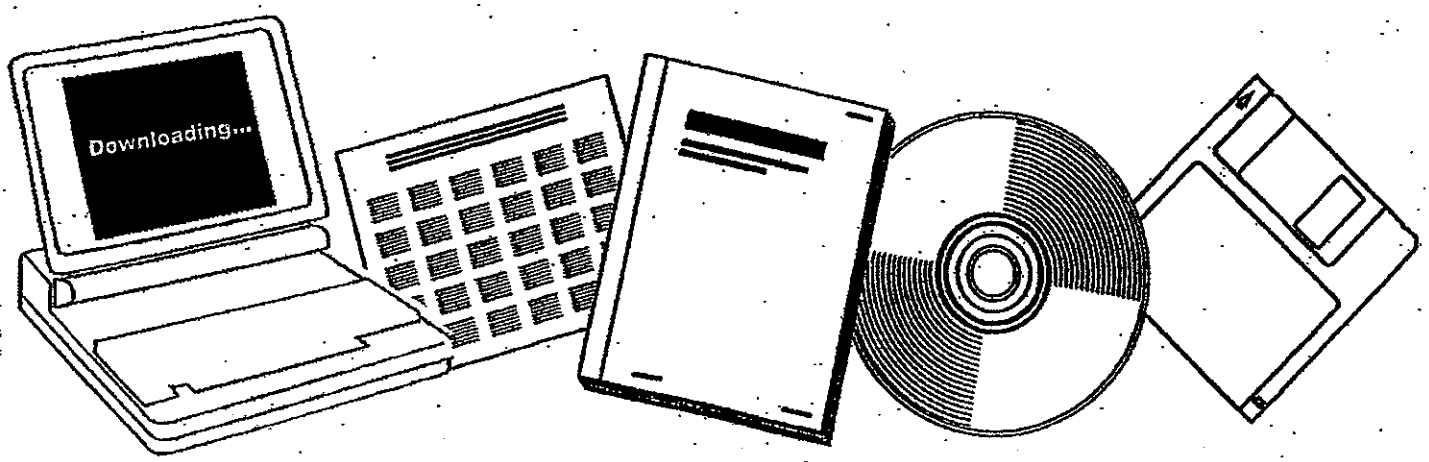

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«The International Bureau undertakes to employ the greatest care in the translation of the Customs Laws and of the Official publications interpreting these Laws, but it is understood that the Governments concerned do not assume any responsibility as to the accuracy of these translations and that in the case of dispute the original text shall be their only guide.» *(Art. 3, Executory Regulations of the International Convention of July 5th, 1890.)*

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CHINA

(PEOPLE'S REPUBLIC OF)

CUSTOMS IMPORT TARIFF [1]

REGULATIONS ON THE IMPORT AND EXPORT TARIFF OF THE PEOPLE'S REPUBLIC OF CHINA

CHAPTER I
GENERAL PROVISIONS

ARTICLE 1

With a view to implementing the policy of opening to the outside world, to promoting foreign economic relations and trade, and to developing the national economy, the present Regulations are hereby formulated in accordance with the Customs Law of the People's Republic of China.

ARTICLE 2

All goods permitted to be imported into or exported out of the customs territory of the People's Republic of China shall be subject to the levy of Customs duties on imports or exports according to the Customs Import and Export Tariff of the People's Republic of China (hereinafter referred to as the Customs Import and Export Tariff) except as otherwise provided for by the State Council.

Goods purchased outside of the customs territory and imported which are originally produced or manufactured in China shall be subject to the levy of import duty according to the Customs Import and Export Tariff.

The Customs Import and Export Tariff is an integral part of the present Regulations.

ARTICLE 3

The Tariff Commission established by the State Council is charged with the responsibility of formulating the guidelines, policies and principles for drawing up and/or amending Regulations on the Import and Export Tariff of the People's Republic of China and the Customs Import and Export Tariff, to examine the draft of amendments to the tariff, to set temporary tariff rates and to examine and approve the partial adjustment to the tariff rates.

The composition of the Tariff Commission is prescribed by the State Council.

ARTICLE 4

Both the consignee of imports and the consignor of exports are persons obligated to pay customs duties.

The agent entrusted to go through the related customs procedures shall abide by all provisions of the present Regulations pertaining to his client.

ARTICLE 5

Regulations on the levy of import duties on incoming passengers' luggage and articles and on personal postal matters shall be formulated by the Tariff Commission.

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[1] As at 1.1.2001.

CHAPTER II
APPLICATION OF TARIFF RATES

ARTICLE 6

Tariff rates on imports fall into two categories: general rates and preferential rates. The general rates shall, for the purpose of taxation, apply to goods imported from and produced or manufactured in countries or regions with which the People's Republic of China has concluded no agreement for reciprocal tariff preference; the preferential rates shall apply to goods imported from and produced or manufactured in countries or regions with which the People's Republic of China has concluded such agreements.

Subject to special approval by the Tariff Commission under the State Council, the preferential rates may, for the purposes of taxation, be applied to imported goods to which the general rates are otherwise applicable according to the provisions of the preceding paragraph.

A special duty may be imposed on goods imported from any country or region which imposes a discriminating duty or effects other forms of discriminating treatment in respect of imported goods originating in the People's Republic of China. The description of the goods subject to the imposition of the special duty, its tariff rates, and the date of its inception and discontinuance shall be determined by the Tariff Commission and promulgated for enforcement.

ARTICLE 7

Import and export goods shall be classified under the appropriate heading or subheading in the light of the Interpretation Rules set forth in the Customs Import and Export Tariff and, for the purpose of taxation, the tariff rates applicable shall be applied accordingly.

ARTICLE 8

Customs duties shall be levied on imports or exports at the tariff rates in effect on the date of declaration for imports or exports by the consignee or consignor or his agent.

Imports which are permitted by the Customs to be declared prior to their entry shall be subject to the levy of import duties at the tariff rates in effect on the date of entry of the means of transport involved.

ARTICLE 9

The tariff rates in effect on the date when the import or export goods are first declared for importation or exportation shall apply in the recovery or refund of the import or expert duties. Specific provisions in respect thereof shall be formulated by the Customs General Administration.

CHAPTER III
VERIFICATION OF THE DUTY-PAYING VALUE

ARTICLE 10

The duty-paying value of the goods to be imported shall be assessed according to the CIF price based on the transaction value verified by the Customs. The CIF price shall cover the price of the goods, packing charges, freight, insurance premiums and other service charges incurred prior the unloading of the goods at the place of destination in the customs territory of the People's Republic of China.

ARTICLE 11

In case the CIF price of the import goods is unable to be ascertained after examination by the Customs, it shall, for the purpose of payment of duties, be assessed by the Customs on the basis of the following prices in order of precedence:

A) The transaction value of the identical or similar goods imported from the same country or area;

B) The transaction value of the identical or similar goods on the international market;

C) The wholesale price of the identical or similar goods on the domestic market, less the import duties levied and other taxes collected in the process of importation, the charges on transportation and storage after importation, the business expenses and the profits;

D) The value assessed by the Customs by means of other reasonable methods.

ARTICLE 12

The duty-paying value of mechanical appliances, means of transport or any other goods which have been shipped out of the Customs territory for repairs with the declaration for exports made in advance and shipped back into the customs territory within the time-limit set by the Customs, shall be identical to the charges on the repairs and the cost of materials and spare parts used for the repairs, both of which shall be subject to examination and approval by the Customs.

ARTICLE 13

The duty-paying value of goods which are shipped out of the customs territory for outward processing with the declaration for exports made to the Customs in advance and shipped back into the customs territory within the time limit set by the Customs shall be identical with the difference between the CIF price of the processed goods at the time of entry and the CIF price of the original goods shipped out of the customs territory or of the identical or similar goods at the time of entry.

The description of the goods referred to in the preceding paragraph and the specific measures for their regulation shall be separately provided by the Customs General Administration.

ARTICLE 14

The duty-paying value of goods imported on lease (including for rent) shall be assessed according to the rental for the goods, which is subject to examination and approval by the Customs.

ARTICLE 15

The duty-paying value of goods imported shall include payments of charges and fees made to parties out of the customs territory as regards the patents, trademarks, copyrights, know-how, computer software and information relative to the goods imported for the purpose of their production, use, publication or circulation in the customs territory.

ARTICLE 16

The duty-paying value of goods to be exported for sale shall be identical to the FOB price of the goods with the export duties deducted. The above FOB price shall be subject to examination and approval by the Customs. In case the FOB price is unable to be ascertained the duty-paying value shall be assessed by the Customs.

ARTICLE 17

The consignors or consignees of import or export goods or their agents are obligated to declare to the Customs the true transaction value of import or export goods. If such value declared proves apparently lower or higher than the transaction value of identical or similar goods, the duty-paying value shall be determined by the Customs in accordance with the relevant provisions of the present Regulations.

ARTICLE 18

The consignee of imports or consignor of exports or his agent, shall, at the time of submitting the declaration for imports or exports, produce to the Customs the invoices indicating the real price, freight, insurance premiums and other expenses incurred for the goods (with manufacturers' invoices, if any), packing lists and other relevant papers for examination and approval by the Customs.

All the above invoices and papers shall be signed and stamped by the consignee or consignor or his agent to the effect that they are true and correct.

ARTICLE 19

The consignee or consignor or his agent shall produce the invoices and other papers necessary for the Customs to assess the duty-paying value of the goods to be imported or exported, if necessary, the Customs may examine the relevant contracts, accounts, bills and other papers of both the buyers and the sellers or make any further investigation. The Customs may also check the above documents and papers even after the levy of customs duties on and the release of the goods in question.

ARTICLE 20

In case the consignee or consignor or his agent should fail to produce the relevant documents and papers stipulated in Article 18 for examination by the Customs at the time of submitting the declaration for imports or exports, customs duties already collected shall not be refunded even though the relevant documents and papers are subsequently produced to the Customs.

ARTICLE 21

In case the CIF price of imports, the FOB value of exports, the rental for imported or exported goods, the charges on repairs or the cost of materials and spare parts are in terms of foreign currencies, they shall be converted into RMB at the middle price between the buying and selling prices quoted by the State Administration of Foreign Exchange on the date of issuance of the Duty Memo. In case the exchange rate of any foreign currency is not available in the quotation, the Customs may apply the exchange rate set by the above administrative organ.

CHAPTER IV
PAYMENT, REFUND AND RECOVERY OF CUSTOMS DUTIES

ARTICLE 22

The consignee or consignor or his agent shall pay customs duties at the designated bank within seven days (excluding Sundays and national holidays) after the date of issuance of the Duty Memo by the Customs, in case of any payment in arrears, the Customs may order the fulfilment of the payment and 1‰ of the total amount of the overdue customs duties shall be charged as a fee for delayed payment per day from the eighth day to the date of fulfilment of the payment.

ARTICLE 23

The Customs shall levy customs duties and charge fees for delayed payment in terms of RMB except as otherwise provided for.

ARTICLE 24

The Customs shall issue receipt for any customs duties collected or any fees for delayed payment charged. The form of the receipt shall be prescribed by the Customs General Administration.

ARTICLE 25

In any of the following cases, the consignee or consignor or his agent may, within one year from the date of payment of customs duties, claim for a refund from the Customs by submitting to the Customs a written application with good reasons supplied and the receipt for the paid customs duties attached:

A) any amount of customs duties is overpaid as a result of the wrong assessment by the Customs;

B) any duty-paid goods imported, which are exempted from examination by the Customs, are discovered to be shortlanded with the verification of the Customs;

C) any duty-paid goods to be exported are not shipped for some reason and declared to the Customs as shut-out cargo with the verification of the Customs.

The Customs shall reply in writing within 30 days from the date of receipt of the application for the refund of the duty paid and notify the applicant of its decision.

ARTICLE 26

In case customs duties are short-levied or not levied on imports or exports, the Customs may, within one year after the date of payment of customs duties or the date of release of the goods, recover the amount of customs duties short-levied or not levied. If any imports or exports are short-levied or not levied owing to an act in violation of the Customs regulations by the consignee or consignor or his agent, the Customs may recover from him the customs duties short-levied or not levied within three years.

CHAPTER V
REDUCTION OR EXEMPTION OF CUSTOMS DUTIES AND THE PROCEDURES FOR EXAMINATION AND APPROVAL

ARTICLE 27

Goods falling into any of the following categories may be exempted from the levy of customs duties upon verification by the Customs:

A) a consignment of goods, on which customs duties are estimated below RMB 10 Yuan;

B) advertising material and samples, which are of no commercial value;

C) goods and materials, which are rendered gratis by international organizations or foreign governments;

D) fuels, stores, beverages and provisions for use en route loaded on any means of transport, which is in transit across the frontier.

In case any goods exported should be shipped back into the customs territory for some reason, the original consignor or his agent shall submit a declaration for entry with the original documents and papers attached and verified by the Customs, and the levy of import duties may be exempted. However, the export duties already collected shall not be refunded.

In case any goods imported should be shipped back out of the customs territory for some reason, the original consignee or his agent shall submit a declaration for return with the original documents and papers attached and verified by the Customs, and the levy of export duties may be exempted. However, the import duties already collected shall not be refunded.

ARTICLE 28

The Customs may in consideration of existing circumstances, grant reduction or exemption of customs duties on any goods falling into any of the following categories:

A) Goods damaged, destroyed, or lost en route to the customs territory or at the time of unloading;

B) Goods damaged, destroyed or lost by force majeure after unloading but prior to release;

C) Goods discovered already leaky, damaged or rotten at the time of examination by the Customs, provided that the cause proves to be any other than improper storage.

ARTICLE 29

Customs duties shall be reduced or exempted on goods and articles in accordance with the relevant provisions of international treaties, to which the People's Republic of China is a contracting or acceding party.

ARTICLE 30

The levy of customs duties may be exempted temporarily on samples, exhibits, engineering equipment, vehicles and vessels for construction, instruments and tools for installation, cinematographic and television apparatus, containers of goods, and theatrical costumes and paraphernalia, which are permitted by the Customs to be temporarily shipped into or out of the customs territory and reshipped out of or into the customs territory within six months, provided that a deposit of an amount equal to that of the customs duties or a guarantee bond is submitted to the Customs by the consignee or consignor.

The time limit stipulated in the preceding paragraph may be extended at the discretion of the Customs. Machinery for construction, engineering vehicles and vessels and the like which are temporarily admitted on their importation with a time-limit that is subsequently extended upon approval by the Customs, shall be subject to the levy of import duties during the period of extension according to the time of their use. Specific measures for the purpose of the levy shall be separately prepared by the Customs General Administration.

ARTICLE 31

Import duties on raw materials, subsidiary materials, spare parts, accessories, components and packing materials imported for processing or assembling on behalf of manufacturers or traders out of the customs territory, or for the manufacture of goods to be exported, may be exempted in accordance with the quantities of the materials, etc. actually used in the processing or assembling, or used in the manufacture of the export goods; alternatively, the import duties may be collected upon importation first and then refunded in accordance with the quantities of the finished products actually exported.

ARTICLE 32

Regulations on the levy or exemption of customs duties on free replacement goods shall be separately formulated by the Customs General Administration.

ARTICLE 33

Customs duties shall be reduced or exempted in accordance with the provisions set out in the relevant regulations on goods imported into or exported out of designated areas, such as special economic zones or designated enterprises, such as Chinese-foreign joint ventures, Chinese-foreign contractual joint ventures and wholly foreign-owned enterprises, and also on goods falling into the category of preferential treatment by laws and regulations.

ARTICLE 34

In case the consignee or consignor or his agent applies for an *ad hoc* reduction or exemption of customs duties on imports or exports, a written application with good reasons stated and necessary documentary evidence provided shall be submitted to the Customs for examination prior to the importation or exportation of the goods. The Customs shall verify and transmit the application to the Customs General Administration, which may, in accordance with the relevant regulations formulated by the State Council, examine and approve it with or without consulting the Ministry of Finance.

ARTICLE 35

Import goods which are given tariff preference for reduction or exemption in respect of specified duties in accordance with laws and regulations of the State shall, in case of their being sold, transferred, or devoted to other uses upon approval by the Customs within the period of its supervision, be subject to recovery of duties ascertained by the assessment of the value of the import goods, taking into account their depreciation on the basis of the length of time of their use. The period of supervision shall be separately stipulated by the Customs General Administration.

CHAPTER VI
PROCEDURES FOR APPEAL

ARTICLE 36

Tax-bearers who dissent from the decision of the Customs on the collection, reduction, recovery or refund of duties shall be obligated first to pay such duties as are ascertained by the Customs and then, within 30 days from the date of issuance of the Duty Memo, submit an application in writing to the Customs for a reconsideration of the case. Applications submitted beyond the time limit prescribed shall not be considered.

ARTICLE 37

The Customs shall make its decision on the appeal within 15 days from the date of receipt of the appeal.

Should the person obligated to pay customs duties refuse to accept the decision, he may appeal to the Customs General Administration for reassessment within 15 days from the date of receipt of the note of decision.

ARTICLE 38

The Customs General Administration shall make its decision on the appeal within 30 days after the date of receipt of the appeal and accordingly notify the person obligated to pay customs duties of the decision.

Should the person obligated to pay customs duties find the decision made by the Customs General Administration unacceptable, he may bring the case to the People's court within 15 days from the date of receipt of the note of decision.

CHAPTER VII
PENALTIES

ARTICLE 39

Any act in violation of the present Regulations, which constitutes the crime of smuggling, or of the regulations on the Customs supervision and control shall be dealt with in accordance with the Customs Law of the People's Republic of China, implementing Regulations on Imposing Administrative Penalties under the Customs Law of the People's Republic of China and other relevant laws and regulations.

CHAPTER VIII
SUPPLEMENTARY PROVISIONS

ARTICLE 40

The Customs shall, in accordance with the relevant regulations, reward any individuals or units who provide any information or assistance which leads to the uncovering of any evasion of customs duties in violation of the present Regulations and keep the identities of such individuals or units strictly confidential.

ARTICLE 41

The Customs General Administration is authorized to interpret the present Regulations.

ARTICLE 42

The present Regulations shall come into force on April 1, 1992

General rules for the interpretation of the Harmonized System

Classification of goods in the Nomenclature shall be governed by the following principles:

1. The titles of Sections, Chapters and sub-Chapters are provided for ease of reference only; for legal purposes, classification shall be determined according to the terms of the headings and any relative Section or Chapter Notes and, provided such headings or Notes do not otherwise require, according to the following provisions:

2. a) Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished, provided that, as presented, the incomplete or unfinished article has the essential character of the complete or finished article. It shall also be taken to include a reference to that article complete or finished (or falling to be classified as complete or finished by virtue of this Rule), presented unassembled or disassembled.

   b) Any reference in a heading to a material or substance shall be taken to include a reference to mixtures or combinations of that material or substance with other materials or substances. Any reference to goods of a given material or substance shall be taken to include a reference to goods consisting wholly or partly of such material or substance. The classification of goods consisting of more than one material or substance shall be according to the principles of Rule 3.

3. When by application of Rule 2 b) or for any other reason, goods are, *prima facie*, classifiable under two or more headings, classification shall be effected as follows:

   a) The heading which provides the most specific description shall be preferred to headings providing a more general description. However, when two or more headings each refer to part only of the materials or substances contained in mixed or composite goods or to part only of the items in a set put up for retail sale, those headings are to be regarded as equally specific in relation to those goods, even if one of them gives a more complete or precise description of the goods.

   b) Mixtures, composite goods consisting of different materials or made up of different components, and goods put up in sets for retail sale, which cannot be classified by reference to 3 a), shall be classified as if they consisted of the material or component which gives them their essential character, insofar as this criterion is applicable.

   c) When goods cannot be classified by reference to 3 a) or b), they shall be classified under the heading which occurs last in numerical order among those which equally merit consideration.

4. Goods which cannot be classified in accordance with the above Rules shall be classified under the heading appropriate to the goods to which they are most akin.

5. In addition to the foregoing provisions, the following Rules shall apply in respect of the goods referred to therein:

   a) Camera cases, musical instrument cases, gun cases, drawing instrument cases, necklace cases and similar containers, specially shaped or fitted to contain a specific article or set of articles, suitable for long-term use and presented with the articles for which they are intended, shall be classified with such articles when of a kind normally sold therewith. This Rule does not, however, apply to containers which give the whole its essential character;

   b) Subject to the provisions of Rule 5 a) above, packing materials and packing containers presented with the goods therein shall be classified with the goods if they are of a kind normally used for packing such goods. However, this provision is not binding when such packing materials or packing containers are clearly suitable for repetitive use.

6. For legal purposes, the classification of goods in the subheadings of a heading shall be determined according to the terms of those subheadings and any related subheading notes and, *mutatis mutandis*, to the above rules, on the understanding that only subheadings at the same level are comparable. For the purposes of this rule the relative section and chapter notes also apply, unless the context otherwise requires.